Milliman Research Report

Prepared by:

Carl Friedrich
Sue Saip

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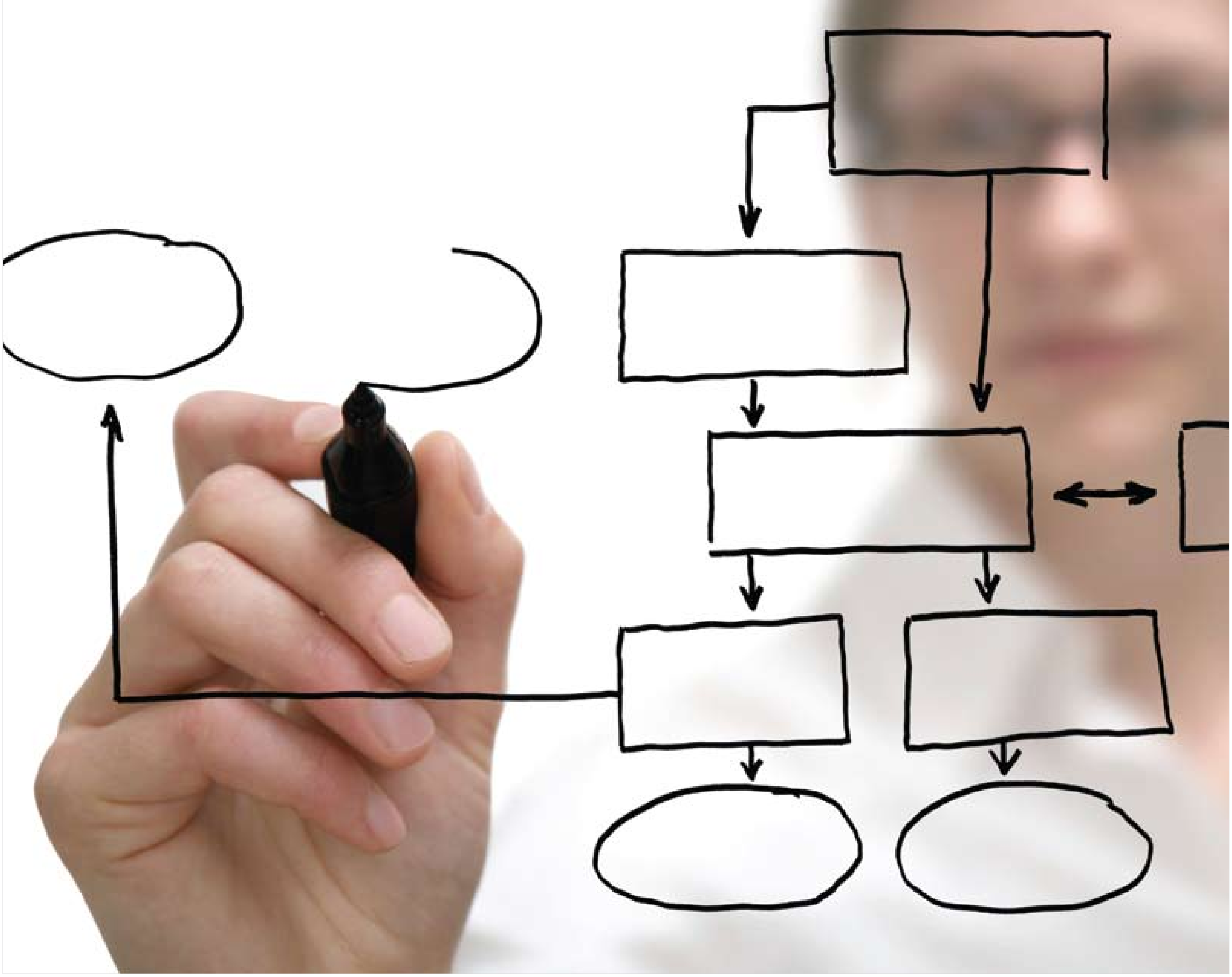
Annuity/Long-term Care Insurance Combination Products



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INTRODUCTION

This paper is intended to be a supplement to the Milliman, Inc. report of May 2007, *Long-term Care Insurance Combination Products: A New Opportunity*.

MARKET OPPORTUNITIES

The Pension Protection Act of 2006 (PPA) opened the door for combination products featuring long-term care riders on non-qualified annuity products by addressing the tax treatment of such plans.

The Pension Protection Act of 2006 (PPA) opened the door for combination products featuring long-term care riders on non-qualified annuity products by addressing the tax treatment of such plans. The PPA specifies that, effective Jan. 1, 2010, qualified long-term care insurance (LTCI) benefits paid out of these plans are generally paid as tax-free LTCI benefits. The law also allows for 1035 exchanges into combination plans. This is noteworthy in light of the hundreds of billions of dollars deposited in existing non-qualified annuities issued after Dec. 31, 1996, for which these rules may apply. This new tax advantage and changes in the stand-alone LTCI market are creating a tremendous opportunity for those carriers entering the combination market. We have seen about 10 annuity/LTCI combinations introduced into the market, and current product development activity in the works suggests this will more than double within the next year.

Consumers may be driven from stand-alone LTCI products to combination products for a number of reasons. Premiums on the stand-alone products have increased because of updated interest and lapse assumptions. As a result, the stand-alone product is unaffordable for many who would benefit from LTCI. Also, buyers dislike the idea of paying premiums for many years and possibly getting nothing in return. Combination annuity/LTCI designs can address these concerns.

Industry perspectives on the target market for annuity/LTCI combination plans vary by company. A few general factors may be considered regarding the target market for such plans. The 50-to-80 age group seems to be the prime age group to target because the maximum issue age for LTCI coverage is usually age 80, which is due to affordability and underwriting concerns, while most below age 50 lack the immediate interest or assets to purchase this coverage. Also, this segment of the population is expected to grow significantly over the next 10 to 20 years. Size of the account value is another general factor, as most combination annuities define monthly LTCI benefits as a percentage of the account value at the time of original claim. Consideration must be given for those levels that would not produce meaningful benefits for LTCI under the combination plan design.

One major LTCI player views its target market as split into two groups. The first group includes LTCI purchasers who recognize the need for LTCI protection and are willing to purchase a stand-alone policy as a solution. The second group includes self-insuring individuals who expect to use existing assets to at least partially fund the LTCI need. This latter group doesn't like the idea of paying premiums and potentially receiving no benefits; a solution for them is annuity/LTCI combination products.

This carrier profiles its potential annuity/LTCI clients in the following way:

- Individuals of ages 55 through 75 who are retired or close to retirement and are generally optimistic about the future. They generally don't think long-term care will be needed.
- Those who recognize that the risk of needing long-term care is great and the cost too high to ignore, and who are too wealthy to qualify for Medicaid.
- Individuals who are looking for a tax-advantaged way to plan for the potential costs of long-term care, but are not as concerned with tax-efficient asset transfer to heirs.

The financial position for its target clients may be categorized as follows:

- Invested assets of at least $300,000, not including home and qualified plan assets

- Currently self-insuring the risk of long-term care, and may also have emergency funds in annuities, CDs, or low-risk mutual funds

For these clients, an asset-based LTCI solution may be an attractive alternative, as it covers the need for LTCI benefits and protects assets so they can grow tax-deferred.

Another major LTCI player takes a slightly different approach in segmenting client views based on the asset base for its target clients:

- Asset leverage is the sales theme for clients with assets in excess of $10 million.

- Income protection via combination plans is the focus for clients with assets of $750,000 to $10 million.

- Stand-alone LTCI is targeted for those clients with assets of less than $750,000.

The ultimate positioning in the market for any specific combination plan will be influenced by the particular design of the product, as there are a variety of existing and emerging designs that will fit different market needs.

MAJOR DESIGN APPROACHES

The benefit payout structure is typically defined as an accelerated benefit (AB), whereby LTCI benefit payments are accompanied by concurrent reductions from the annuity account value without assessing surrender charges. This is usually combined with some form of an *independent* benefit that is not supported by account value reductions. The benefit is paid monthly and is usually expressed as a percent of the annuity account value at the time of initial claim. Charges under most designs are level percentages (expressed in basis points) of the account value. In essence, as the account values grow, new layers of LTCI coverage are purchased with a new layer of level charges being added. Three approaches along with examples are described below.

In essence, as the account values grow, new layers of LTCI coverage are purchased with a new layer of level charges being added.

Approach 1 (the *tail* design): Benefits are paid first as accelerated benefits until the maximum accelerated benefit (LTCI benefit limit, usually the account value) has been exhausted, followed by a benefit extension (BE) provision that continues independent LTCI payments at the same monthly level for a specified period of time so long as LTCI requirements are met.

Using this approach and an LTCI benefit limit equal to 100% of the account value at the start of the claim, the following options could be offered as an example:

> *Option 1.A*: Acceleration benefits are defined as 2% of the LTCI benefit limit payable for 50 or more months, with 25 or 50 months of benefit extensions. Note that most companies pay out the interest earnings on the account value as part of the acceleration benefit, thus explaining in the example here why the months of payout would exceed 50. Optimal tax positioning would continue payments until the account value and all interest earnings during the long-term care payouts would be fully drained, thus extending the payout period beyond 50 months. Note that the BE period is not increased as a result of interest earnings on the account values during the AB claim period. Another variation of this concept is to pay out a monthly LTCI amount equal to the account value divided by 48, so it looks like a four-year benefit period.
>
> *Option 1.B*: Another option commonly offered to applicants would be a monthly payment of 4% of the LTCI benefit limit payable for 25+ months, with 25 or 50 months of benefit extensions.

For the tail design, selections of anywhere from 1% to 6% monthly are available. Too many choices may overly complicate the decision-making process for applicants, while too few may not allow for a monthly benefit that fits the client's needs.

Several companies have opted to express the BE payout period as one or two times the AB payout period. This comes across well from a marketing standpoint, but can be a bit confusing if the AB benefits pay out interest earnings on the account value during the LTCI AB claim period, whereas the extension benefits would continue for a defined period ignoring such interest earnings.

Approach 2 (the *coinsurance* design): Accelerated and independent benefits are paid concurrently in fixed proportions until the LTCI benefit limit is exhausted.

For example, using the same LTCI benefit limit as defined for Approach 1 (the tail design) and with 80% of the benefit payment coming from the account value, the following options could be offered:

> *Option 2.A*: 1/48 of the LTCI benefit limit payable for 60+ months
>
> *Option 2.B*: 1/24 of the LTCI benefit limit payable for 30+ months

This approach has market appeal in that the structure creates *new money* for the insured, i.e., independent benefits are paid while accelerated benefits are paid. Some companies have indicated that their consumer focus groups or producers have favorably reacted to this structure in that it provides significant insurance benefits earlier than under the tail design. However, it can be more costly and there is some additional administrative complexity involved.

Approach 3 (the *pool* design): Benefit payments are based on a maximum LTCI pool amount defined at issue. The excess of the maximum LTCI pool amount over the account value defines a net amount at risk. Charges under this structure may be set as a rate assessed per dollar of net amount at risk. The portion of the benefit payment that is an accelerated benefit increases as the account value grows, while the independent benefit portion decreases. Benefit payments reduce the remaining maximum LTCI pool and account value on a dollar-for-dollar basis until the account value is depleted, at which point all remaining monthly benefits are independent benefits and are payable so long as LTCI benefit triggers are met and the maximum LTCI pool has not been paid out in full. A variation of this approach would be to introduce an element of coinsurance and reduce account values by less than a dollar for every dollar of LTCI benefits paid.

An example of this approach is to set the maximum LTCI pool amount equal to 300% of the account value at issue and to offer the following options:

> *Option 3.A*: Presume the account value is $100,000 in this case. Two percent of the maximum LTCI pool amount of $300,000 is payable for 50 months or until the depletion of the account value, if later; note that if a claim were to occur immediately after issue, this would translate to monthly benefits of 6% of the account value ($6,000) payable for more than 16 months until the account value is depleted, with independent benefit extensions payable thereafter for the remainder of the 50 months.
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> *Option 3.B*: 4% of the maximum LTCI pool amount payable for 25 months or until the depletion of the account value, if later; note that the benefit would normally end after 25 months in this case, unless the account value grew to a level in excess of the maximum LTCI pool amount, in which case monthly benefits would continue so long as requirements are met and positive account value exists in the contract.

As an alternative, the maximum LTCI pool might be unlinked from the initial account value and selected by the client at issue, which would work much better for flexible premium contracts because flexible premium contracts are likely to have low early duration account values that would not deliver meaningful LTCI benefits if those benefits are linked to the account value.

The structure chosen will have different implications in terms of tax treatment, the cost of the rider, and degree of risk to the company.

Richer benefits, as in the above examples that provide for a maximum payout of 200% to 300% of account value, are more costly to the consumer and increase risk for the company. The example in Approach 1 may be less risky than the example in Approach 2 because the independent benefit is deferred. The charge structure for Approach 3 would typically be defined in terms of the net amount at risk. This approach mitigates some risk to the company, as the charges are greater if there is not a great deal of account value growth and more independent benefits are paid, and smaller when the account value growth has been high and a larger portion of the benefits will be accelerated benefits.

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The target market is another consideration for determining the appropriate design. The account value size may drive the design decision to meet the requirements for favorable tax treatment. Combinations of design structures may be offered. Different combinations of coinsurance percentages and benefit extension periods could be offered to best meet the needs of clients, as well as providing flexibility to the insurer.

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There are a growing number of carriers selling annuity/LTCI combination coverage. Major carriers in this market include Genworth, United of Omaha, Midland, Conseco, Guaranty Income Life, John Hancock, and State Life/OneAmerica (formerly Golden Rule). Virtually all utilize the tail design, while one uses the pool design, one uses a coinsurance design, and a number of new companies have been exploring the more complex combinations.

INFLATION BENEFITS

Companies that offer LTCI insurance are required under the Long-term Care Insurance Model Regulation to offer contract holders the option to purchase inflation protection providing for benefit increases of at least 5% compound per year.

Companies that offer LTCI insurance are required under the Long-term Care Insurance Model Regulation to offer contract holders the option to purchase inflation protection providing for benefit increases of at least 5% compound per year. The following are two common designs for an inflation protection benefit.

Annual pour-in: Under this approach, the contract holder is allowed to pour in amounts at contract anniversaries that are sufficient to increase the monthly benefit by 5% per year. In years when the interest growth in account value is 5% or higher, no pour-in amount would be required. As a protection against anti-selection, the inflation protection benefit could be frozen if the pour-in amount is not paid, and future increase options would not be offered. The annual pour-in approach adds some complexity to administration because the pour-in amount needs to be determined each year and the status of the option must be tracked.

It is possible to structure the inflation benefit to waive the requirement of additional pour-in amounts during a claim, but this would add cost to the rider because it would effectively transform accelerated benefits into independent benefits since the account value would be depleted faster.

Fixed annual charge: An alternative to the pour-in approach is to charge for the inflation protection benefit directly. Some contracts increase the LTCI benefit limit on each anniversary by 5% and impose a level basis-point charge against the account value (or in the case of Approach 3, against the net amount at risk). If the benefit payout follows Approach 3 above, the maximum LTCI pool amount is increased by 5% each year. In this case, the level charge is expressed as a rate times the initial monthly benefit amount.

The inflation benefit is expensive and might not be used by very many customers. It increases the risk to the company because of adding exposure to persistency and interest-rate assumptions. It can complicate the sales process, as it may be difficult to understand. On the other hand, most stand-alone LTCI buyers purchase inflation protection. There is some thought under the tail design or the coinsurance design, where the LTCI benefits are defined based on account values, that the natural growth of account values within these contracts addresses the needs of most insureds for inflation protection. The need for inflation protection is more significant under the pool design.

ANNUITY MATURITY AGE

Some LTCI riders terminate at the contract's maturity date, the latest date at which the contract can be annuitized. However, terminating the rider coverage when the policyholder is at an advanced age and is thus more likely to require the coverage is not ideal. Some companies handle this issue by allowing the policyholder to elect to extend the maturity date under certain circumstances. This is based on an interpretation that the Internal Revenue Code (IRC) allows for extending the maturity date by no more than the policyholder's life expectancy at that point in time. However, this may pose issues if the approach is utilized at very advanced ages.

A second approach is to allow the annuitant to elect a reduced paid-up benefit at maturity, where the maximum LTCI payout is equal to some percentage of the account value at maturity. The percentage might be driven by the relationship between the account value and the independent maximum lifetime benefit at the time of maturity, so in essence only the independent benefits are preserved. A recent private letter ruling indicated that if the LTCI coverage is retained after annuitization and the insured meets eligibility requirements for LTCI, the annuity payments will be considered LTCI benefits for tax purposes. Another variation would retain a charge for the benefit based upon the account value at the time of maturity, deducted monthly from the annuity payments. Note that any reduction in LTCI maximum benefits to include only the independent benefit portion runs the risk of providing a sub-optimal tax structure compared to the first approach above, because payout of account values under annuitization or surrender may generate taxable income as opposed to the payout of LTCI benefits being tax-free.

POLICYHOLDER TAXATION ISSUES

A key provision is that LTCI payouts, even if they are accompanied by some reduction in account values in the base plans, are tax-free LTCI benefits.

The PPA provides for favorable treatment of tax-qualified LTCI riders attached to non-qualified annuities, for tax years beginning after Dec. 31, 2009 (note that this is applicable to policies issued prior to that date as well, to the extent they were issued after Dec. 31, 1996). A key provision is that LTCI payouts, even if they are accompanied by some reduction in account values in the base plans, are tax-free LTCI benefits. Section 7702B already provides that amounts received under a qualified LTCI contract are excludable from income, subject to annually adjusted limits in the case of per diem plans which pay fixed periodic amounts that might exceed actual LTC expenses incurred. Further, as stated in the technical explanation of the act by the Joint Committee on Taxation,

> *"As a result, if the applicable requirements are met by the long-term care portion of the contract, 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 life insurance contract's death benefit or cash surrender value or in the annuity contract's cash value."*

The statute requires that for these rules to apply, the contract must be an insurance contract, and this in turn implies that a meaningful amount at risk for the insurance company needs to be present. This is one of the key factors to consider when designing the benefit structure.

However, the statute requires that for these rules to apply, the contract must be an insurance contract, and this in turn implies that a meaningful amount at risk for the insurance company needs to be present. This is one of the key factors to consider when designing the benefit structure. On May 8, 2009, the IRS issued private letter ruling 200919011 that included the view that the coinsurance design presented in that case did reflect a meaningful amount at risk.

There is a view shared by many that a rider that includes both accelerated benefits and benefit extensions but not coinsurance benefits, i.e., a tail design or a pool design, collectively does include a meaningful amount at risk to the insurance company. However, it is somewhat less clear that the tail design includes a meaningful amount at risk during the accelerated benefit period than is true for the coinsurance design.

Among other issues covered in the PPA, the Act also clearly states that the charges deducted from the account value to pay for the qualified rider are considered to be non-taxable distributions from the annuity contract; however, such deductions also reduce the investment in the contract (referenced below as *basis* in the contract).

The PPA does not directly address the effect that the payment of LTCI benefits has on the contract's basis. A number of companies have taken the position that the basis is not reduced by the payment of LTCI benefits from the contract's account value. Under this interpretation, the taxable gain in the contract may be significantly reduced, in some cases to zero, if it is used to provide LTCI benefits. In making this interpretation, companies note that the PPA states that the portion of the contract providing LTCI coverage is a separate contract. As such, it would seem inconsistent to treat benefit payments from one contract (the LTCI rider) to reduce basis in the first contract (the annuity). This argument is further supported by the observation that the charge for the rider, i.e., the distribution of the cost of the LTCI coverage taken from the annuity account value, serves as a reduction to the basis in the annuity. Subjecting the annuity basis to further reductions related to LTCI benefit payments would appear to be an inconsistency that in essence would create double taxation. On the other hand, private letter ruling 200919011 included a different view on this subject. Subsequent to that ruling, there has been discussion of this topic within the industry, and in one recent forum an IRS representative appeared to express some openness for further consideration of this question. These issues require review by companies' tax counsel, as there may be material differences in taxation of remaining annuity benefits (if any exist) that are paid out by virtue of surrender or death.

Following are some examples that illustrate the insurance and tax implications of PPA under a couple of different LTCI payout scenarios:

Case 1: A 60-year-old annuity purchaser depositing $100,000 ($100K), who at age 80 needs 24 months of accelerated LTCI benefits and another 24 months of tail benefits.

- Assuming an annuity purchase without the LTCI rider, she cashes out $219K at age 80 (reflecting a 4% annual growth) and pays $36K of taxes on gain (assuming a 30% tax rate), with a net of $183K after tax.

- In contrast, with an LTCI rider attached that pays out up to 200% of account value, with a cost of 65 basis points per year assessed against the account value, the annuity grows to $193K, so the contract pays out $386K tax-free.

- Note that this ignores potential tax benefits of itemized deductions for LTCI medical expenses that are not reimbursed, which might dampen some of the differentials above for many insureds.

Case 2: A second scenario where the same client eventually needs six years of care after the purchase of a more expensive 24-month accelerated benefit plus a 48-month extension of benefit tail, effectively creating a total potential benefit of three times the account value.

- Assuming an annuity purchase without the LTCI rider, she cashes out $219K (4% annual growth) and pays $36K of taxes on gain (assuming a 30% tax rate), with a net of $183K after tax.

- With the LTCI rider featuring a cost of 90 basis points per year, the annuity funded with $100K grows to $184K so the contract pays out $552K tax-free, versus the $183K without the rider.

These examples highlight the combination of tax benefits and insurance benefits that can leverage accumulation values within annuities. Admittedly, not all consumers will actually utilize long-term care services, and those who do not receive the distribution of all account values as LTCI benefits may not realize all of the tax or insurance benefits of the insurance. But the risk of long-term care utilization is sufficiently high (50% or more at ages 65 and above), and the cost versus potential benefits sufficiently compelling, that we expect producers and companies will appreciate the power of these combination plans.

UNDERWRITING

One of the key obstacles to the success of annuity/LTCI combinations is the complexity of underwriting. Annuities are typically sold without any underwriting, so the long sales process involving extensive underwriting for stand-alone LTCI sales will not work readily with traditional annuity producers. Simplified underwriting with a quick turnaround time will have appeal to those agents.

There are a range of approaches to underwriting for LTCI riders, each with trade-offs between anti-selection risk and underwriting cost.

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The simplest approach is to do extremely limited or no underwriting, with only a few pre-screening questions used to determine whether applicants are eligible. It is easy to sell. But the low cost of underwriting is offset by high risk of anti-selection, especially at the older ages. It also results in a high cost for the LTCI rider. If independent benefits are to be provided, it is likely that some restriction of LTCI benefits will be desirable if no underwriting is performed. The most common such approach is to enforce a waiting period before benefits are payable, such as five or seven years from issue. For example, one company has used guaranteed issue underwriting in the bank channel, but is including a waiting period of six years. Some states and territories will not approve this type of extended waiting period. Further, it is a constraint that may not be very appealing to many consumers and producers, and could lead to complaints if the client does not understand this restriction in coverage.

A moderate level of underwriting can be performed by using a supplemental application that includes a set of questions related to preexisting conditions and cognitive ability. This approach incurs a modest additional cost for underwriting that may not be too onerous for use by many distribution systems. It also allows companies to utilize the contestability provision in the event the application was not completed accurately. There is still some risk of anti-selection and the cost of the rider may still be fairly high.

Additional tools combine the approach above with a policyholder interview (PHI) process and prescription drug database searches to screen key risks, such as cognitive impairment. These approaches may be limited to ages 70 and older, although in many cases we see that companies are using tele-underwriting approaches at all ages, with cognitive impairment tests being pushed down to ages as low as 50 as the cost of some newer telephonically administered cognitive impairment tests is dropping to as low as $10. The producer need not be involved in this aspect of the process. It should be noted that this will have some impact on the amount of time to complete the sale and on placement ratios.

More classic LTCI underwriting would require an attending physician's statement (APS), but these are not generally perceived as viable in most combination distribution outlets. In the current marketplace, the majority of carriers use a simplified issue approach that uses a supplemental application coupled with at least one additional screening mechanism.

DISTRIBUTION PERSPECTIVES AND PRODUCER SURVEY RESULTS

Sales of annuity/LTCI combination products have been growing gradually. Many believe some barriers to the success of this product are related to the following issues:

- Underwriting in the annuity market
- Agent training—difficult to understand the complexities of the product
- PPA changes have not yet occurred (until Jan. 1, 2010)

The benefits to annuity/LTCI combination producers include the following:

- Huge market potential: $750 billion in variable and fixed non-qualified annuity assets relative to $20 billion in stand-alone LTCI in-force annual premium.

- Estimated industry life and annuity combination plan first-year premium for 2008 was $660 million (mostly single premium, including both life and annuity combinations), versus about $600 million of first-year premium on stand-alone LTCI (mostly annual premium).

- Incremental income from renewal trail commission on some plans.

- Higher persistency than stand-alone annuities, thus increasing the value of trail compensation.

Distributors likely to sell annuity/LTCI combination products include annuity producers, LTCI producers, life producers, banks, and financial planners. Each channel may have different acceptance levels of the degree of difficulty in underwriting. It may be that the most effective distribution mechanisms in the future emerge from a collaborative effort of banks or annuity producers who have ready access to clients with target asset profiles that fit this market, working with LTCI specialists who understand the product and underwriting process.

It may be that the most effective distribution mechanisms in the future emerge from a collaborative effort of banks or annuity producers who have ready access to clients with target asset profiles that fit this market, working with LTCI specialists who understand the product and underwriting process.

Milliman recently conducted a survey of top annuity/LTCI combination producers, significant LTCI producers, and large annuity producers in the market. Questions and common responses included the following:

For producers who have not yet sold annuity/LTCI combination products, we asked if they have any interest in selling such products. Nearly all producers that participated in the survey reported that they are interested in selling these products. A key theme among these producers was the need for more information and the lack of education and understanding about the product. There was interest expressed in a variable annuity version of the product, with the belief that a market exists for this type of product. Most view this as an important alternative to stand-alone LTCI coverage. Several producers noted that this provides a solution for cases where the client may not believe they have a need for LTCI and don't want to pay for something that they may never use.

The following questions were asked of all producers who participated in the survey:

1. Please rate the importance of simplified underwriting versus cost of coverage on a scale from 1 to 10, where 1 means simplified underwriting is critical regardless of the coverage cost, and 10 means affordability is most important.

   Responses varied from a rating of 2-3 up to a 10. The average rating by survey participants is a 6. Those producers assigning higher ratings noted that their clients are more interested in affordability and that underwriting is not an issue for them. Some voiced concerns about adverse selection if underwriting is too simplified. One producer indicated that not that many clients qualify for annuity/LTCI combination policies that don't qualify for stand-alone LTCI products. Those responses that were on the lower end of the spectrum believe that simplified underwriting is attractive. One producer stated, “no one likes to get turned down.” Other producers believe there should be a balance between underwriting and cost or that their view is dependent on the client. It was suggested that perhaps a two-benefit chassis be offered: 1) simplified issue with a cost of $x and 2) more rigorous underwriting with a lower cost.

2. Please comment on the appeal of each of the following three designs, where 10 is high appeal and 1 is low appeal, and offer your comments:

   a. Tail design – Benefits are paid first from the account value (usually as a fixed percentage of account value that exists at the time the claim starts) until the maximum accelerated benefit has been exhausted, followed by an extension of benefit provision that continues LTCI payments at the same monthly level for a specified period of time so long as LTCI requirements are met.

      The tail design had the greatest appeal (with a narrow margin over the pool and coinsurance designs) among the producers who participated in the survey. Reasons given for this design being appealing included:

      1. It is the less costly option.
      2. It is simple to explain.
      3. The client will feel he/she has more control with this design.
      4. A design where the benefit increases as the account value grows is appealing.
      5. This is a good design for a high net worth client who want LTCI coverage, but doesn’t want to purchase a stand-alone LTCI policy.

   b. Coinsurance – Accelerated and independent benefits are paid concurrently in fixed proportions until the LTCI benefit limit is exhausted. Viewed another way, as a fixed dollar amount of benefits are paid out, the account value is reduced by a fixed portion (e.g., 50%) of the total benefits.

      The coinsurance design had mixed appeal among producers relative to the tail and pool designs. However, our interviews revealed that many were not familiar with this design and did not understand it.

   c. Pool of money – Benefit payments are a fixed percentage of a maximum LTCI pool amount defined at issue. Benefit payments reduce the maximum LTCI pool and account value on a dollar-for-dollar basis until the account value goes to zero, then remaining amounts are independent benefits. Note that as the account value grows prior to a claim, the portion of future benefits that are an acceleration of account values increases while the independent benefit portion decreases.

      The pool of money design was a close second to the tail design among survey participants. This design is appealing because the benefit is known up front and it is simple to understand and explain. A comment was received that the design would be even more appealing if it included built-in inflation.

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   One producer with a LTCI background, but not an annuity background, stated that all of the designs are complicated and it would be a challenge to explain them to clients.

3. Please rate the importance of the tax advantages in the Pension Protection Act to these products from 1 to 10, where 10 is most important.

   There was a wide range of responses to this question (2 to 10), with an average rating of 7. The majority of responses were that the tax advantages are important. It was noted that a 1035 exchange to an annuity/LTC combination product will provide increased tax efficiency. Another comment was that it is a nice feature that the charges can be deducted from the annuity account value and the client does not need to cut a check. A significant number of responses noted that the tax advantages are not the reason why clients buy the product and that this is just an added bonus. Many clients may not understand the product and aren't aware of the tax implications. They often don't want to get into the details. One producer rated this at the low end and presented his thinking that the tax advantages are the same whether the client buys a stand-alone LTCI policy or the combo version. We should note, however, that his view was not accurate given the provisions of the Pension Protection Act.

4. Please rate the importance of inflation provisions on these products from 1 to 10, where 10 is most important.

   Inflation provisions were rated very high, with an average rating of 8.5. Although inflation was rated high, producers also commented that it can be expensive and may be circumvented with higher benefit amounts. One producer mentioned that he focuses on what the client can afford in terms of premiums and then considers what other features may be built in. A number of producers noted that the need for the inflation provision depends on the product design and that it may not be necessary with some structures. One producer reported that a structure with inflation built into the self-insurance portion of the benefit would be appealing. Another common comment was that age, health, financial situation, and family situation must be considered when determining the need for inflation protection.

A number of producers noted that the need for the inflation provision depends on the product design and that it may not be necessary with some structures.

5. Please describe your views of what compensation incentives are necessary to motivate you to sell these products (circle one or more):

   a. Same as annuity first-year compensation
   b. Higher than annuity first-year compensation
   c. Want a trail commission
   d. Other (Please describe)

   Nearly half of the survey participants responded they are not motivated by compensation and they sell what is best for their clients. It was frequently noted that the current annuity/LTCI combination compensation is viewed as fair. A significant number of producers view commission trails as desirable. One such producer noted this is especially important due to transparency discussions and the industry should not do anything that furthers the bad reputation of the industry. Several producers believe that compensation that is higher than annuity first-year compensation is appropriate for these products. The reason presented was that this is a more complicated sale, and more complicated service is needed for these products. If a producer hasn't done much of this business, the insurer will need to incent the agent to look at it. If they have to learn the product, learn how to position it, and learn how to sell it, then they will need to be compensated for it at levels above typical first-year annuity compensation.

6. Please describe your target clients for this market.

   The survey participants reported that the clients targeted for the annuity/LTC combination market are primarily in the following groups:

   - Clients who are concerned about LTCI, but don't want to buy a stand-alone LTCI policy
   - Clients who can't qualify for or can't afford a stand-alone LTCI policy
   - Higher-net-worth clients who plan to self-insure

   One producer noted that the minimum premium requirement for annuity/LTCI combination products actually defines the target market (higher-net-worth clients). He noted that many of the current structures have minimum premium requirements of $50,000 and above. Another producer mentioned that the use of annuity/LTCI combination products is a more cost-effective way to self-insure and to leverage assets for high-net-worth clients.

7. In your opinion, which of the following factors are reasons why potential clients do not purchase annuity/LTCI combination products? (Please rank from 1 to 7, with 1 being the most common reason).

a.	Too costly	___________
b.	Uncertainty of tax treatment	___________
c.	Underwriting process	___________
d.	Long waiting periods	___________
e.	Perceived lack of need for LTCI coverage	___________
f.	Don't want to use up account value for LTCI	___________
g.	Other (please describe)	___________

The most common reasons why potential clients do not purchase annuity/LTCI combination products are because of the perceived lack of need for LTCI coverage and because of the high cost.

The most common reasons why potential clients do not purchase annuity/LTCI combination products are because of the perceived lack of need for LTCI coverage and because of the high cost. Another common reason for not purchasing such products is the client does not want to use up the annuity account value for LTCI. The remaining factors listed above were cited by a few producers, but were not as common. Other factors reported as reasons for not purchasing annuity/LTCI combination products include: "My kids will take care of me" and the lack of education and understanding on the part of the customer and the producer.

8. Which distribution outlets would likely be the most successful in this market? (Please rank from 1 to 7, with 1 being the most successful).

a.	Annuity producers	___________
b.	LTCI producers	___________
c.	Life insurance producers	___________
d.	Banks	___________
e.	Financial planners	___________
f.	Wirehouses	___________
g.	Other (please describe)	___________

Survey participants selected annuity producers, LTCI producers, and financial planners as distribution outlets that would likely be the most successful in the annuity/LTCI combination market.

Survey participants selected annuity producers, LTCI producers, and financial planners as distribution outlets that would likely be the most successful in the annuity/LTCI combination market. Many participants reported this product would be a good fit for annuity producers, but the product design would need to be simple, as these producers don't know how to sell LTCI. Some producers did not believe that annuity producers would sell this product because most would not want to learn the LTCI portion. For LTCI producers, the combination product may be a natural fit because these producers know the LTCI need. Some producers think the compensation on the combination product will entice LTCI producers to sell this product. Others reported that LTCI producers will continue to sell LTC and would not be interested in selling the annuity/LTCI combination product. There were two extreme views about financial planners selling annuity/LTCI combination products. Many producers believe this product was designed for this distribution outlet. Financial planners look at a client's financial position from a holistic point of view and this product will provide another option/solution. Other producers commented that the product design is too complicated, financial planners don't understand the need for LTCI, and they already have too much on their plate.

9. By what percentage do you expect to increase your sales of these plans:

a.	In 2009 versus 2008?	___________
b.	In 2010 versus 2009?	___________

Limited responses were received to this question because many survey participants had not yet sold these plans or they were uncertain of their future sales due to economic conditions. Increases in 2009 versus 2008 ranged from 0% to 25%, with an average of 11.5% for those participants who reported the percentage increase. For 2010 versus 2009, responses ranged from 0%-5% to 25%-30%, with an average of 12.5%. These responses indicate that those producers who have been selling annuity/LTCI combination products expect to increase their sales of these plans in the future.

10. How important is it for you to offer upgrades to existing annuity policies that would allow for the addition of the LTCI rider, on a scale of 1 to 10, where 10 is most important?

Nearly all responses to this question were rated a 10. Some of the comments received include:

- New products are better.
- This would improve persistency.
- This gives the producer another opportunity to go back to the client and another opportunity for the client to think about his/her LTCI need.

One producer suggested that perhaps the insurer could offer a limited, one-time window to existing clients (e.g., 60 days) where simplified underwriting would be offered with the upgrade.

11. Please indicate approximately how many policies you have sold in the last year:

-Stand-alone LTCI __________
-Annuity/LTCI combo __________

Survey participants reported sales of stand-alone LTCI products from *a few policies* to 200 policies and of annuity/LTCI combination products from zero to 30 policies. The average number of stand-alone LTCI policies sold last year by survey participants was 45 and the average number of annuity/LTCI combination policies sold by the same group was five.

12. Please indicate approximately how many policies you expect to sell in 2010:

-Stand-alone LTCI __________
-Annuity/LTCI combo __________

Limited information was reported by survey participants regarding expectations for sales in the future. For those participants who reported such information, sales ranged from *a few policies* to 300 stand-alone LTCI policies and from zero to nearly 40 annuity/LTCI combination policies.

13. Please offer any other insights on this market into the future

Several survey participants provided additional comments regarding their insights about this market. Comments ranged from "I don't think this product will take off" to "I love this product." One participant voiced concern about the way the product is marketed and that it is necessary to compare the cost of the annuity/LTCI combination product with the cost of a stand-alone LTCI product plus the cost of a stand-alone annuity product. Following are other specific comments received from participants:

- The popularity of asset based LTCI products will increase and it is possible we will see more bells and whistles in the future. However, we need to minimize the cost.

- I want more products, which will result in more competition. Also, there is some concern about the way information about the PPA is released to the marketplace. How is the consumer going to understand this? Will they think they now have LTCI insurance if they have an annuity? It is essential that we educate clients.

- Anytime the client is given more choices, that is good. The annuity/LTCI combination design will likely be more appealing to Baby Boomers than the traditional concept.

- Simplicity is important for both the sales professional and the client so that they understand the product. Perhaps a flexible premium design should be considered since the premium requirement of $50,000 is a significant hurdle.

PRICING SYNERGIES

With many combination designs there are tremendous pricing synergies. Lower lapses would allow the company to possibly double or triple the lifetime base plan profits or to reduce the cost of independent annuity/LTCI benefits to as low as 40% to 60% of stand-alone LTCI rates.

Lapse rate assumptions are a critical pricing element for deferred annuities and stand-alone LTCI plans. Deferred annuities are persistency-supported whereas stand-alone LTCI is lapse-supported, with ultimate lapse rates very low, ranging from 1% to 2%. Combination annuity/LTCI products could approach these levels in the ultimate durations. With many combination designs there are tremendous pricing synergies. Lower lapses would allow the company to possibly double or triple the lifetime base plan profits or to reduce the cost of independent annuity/LTCI benefits to as low as 40% to 60% of stand-alone LTCI rates.

The following example illustrates the pricing synergies that may be realized with an annuity/LTCI combination plan.

In one case in point for age 57 that we recently priced, the present value of base plan profits to the carrier discounted at 10% was $960 (with no LTCI rider and expected annuity persistency). With the rider, and using the commissions illustrated in the Compensation section below, the profits increased to more than $3,000.

At age 67, the present value of base plan profits were $620, and with the rider they rose to more than $1,950.

CLAIM COSTS AND PRICING

The pricing of these products requires financial modeling systems that capture the cash flows of the base plan and the rider, reflecting the product design and interaction among those components of coverage. In addition, the reserves that are used in pricing must reflect appropriate standards for all components of coverage. Some of the greatest challenges in this work are to recognize the different cohorts of clients at any point in time, including those who have never been on claim, those who are currently on claim and are in the process of reducing their account values as a result, and those who previously were on claim but are now off claim (but have lower account values as a result of prior claims). In addition, we expect that it may become more important over time not only to understand how these products perform under simple, deterministic interest rate scenarios, but also to be able to conduct stochastic analysis across a range of scenarios.

Some of the greatest challenges in this work are to recognize the different cohorts of clients at any point in time, including those who have never been on claim, those who are currently on claim and are in the process of reducing their account values as a result, and those who previously were on claim but are now off claim (but have lower account values as a result of prior claims).

Finally, any model is only as good as assumptions being utilized. The most critical assumptions in the pricing of these riders are the LTC incidence and claim termination assumptions. There are a limited number of sources in the industry that are useful and applicable to insured business. Society of Actuaries (SOA) data represents data across a range of companies and products, with a range of underwriting practices. General population nursing home and home health care data is available but not directly applicable to insurance company expectations. Milliman has been a major consultant in the LTCI arena, and has compiled a database of more than $6 billion in LTCI claims. As was true for the SOA studies, it represents data across a range of companies and products, with a range of underwriting practices. However, Milliman consultants have information that allows for adjustments to average data to recognize differences in underwriting, claims management, benefit differences, and other design factors that would materially impact claims costs versus industry norms.

COMPENSATION

Appropriate rewards for producer efforts would typically boost first-year compensation by 75 basis points or more. In addition, there may be merit in consideration of enhanced trail commissions on these products.

The key compensation question relates to whether and by how much agent compensation rates should be higher than for stand-alone annuities, and whether companies are willing to fund some of these costs out of the enhanced profits realized due to enhanced persistency on the base plan. Most companies are realizing the effort involved for producers to learn the nuances of these riders and to educate their applicants regarding the coverage and choices. Appropriate rewards for producer efforts would typically boost first-year compensation by 75 basis points or more. In addition, there may be merit in consideration of enhanced trail commissions on these products. This might be funded by the enhanced profitability derived on the base plan as a result of enhanced persistency.

The following example shows one potential compensation structure for a $100,000 single-premium deferred annuity (SPDA) with an LTCI rider:

Base plan commission: 6%-8% of $100,000
Incremental rider commission: 1% of $100,000, plus 15 basis points per year on account values

From the agent's perspective, the rider presented an opportunity to enhance compensation by $1,000 at issue plus a renewal stream of $150 per year and growing. Charges for the rider in this case might be in the range of 80 to 125 basis points per year.

IN-FORCE PROGRAMS

In light of changes in the tax law that take effect in 2010, which include allowed 1035 exchanges from life or annuity policies into combination plans, companies might consider designing special programs aimed at their in-force business. The internal exchange of a life policy or annuity policy into an annuity/LTCI combination policy might be a way to further enhance persistency for the in-force business and thus boost profitability. Obstacles include agent relationships, efficient client contact, and appropriate compensation. In addition, GAAP accounting rules may require a write-down of DAC asset balances upon upgrades to in-force policies, thus resulting in short term one-time GAAP losses that would presumably be offset by considerably higher future GAAP income.

The internal exchange of a life policy or annuity policy into an annuity/LTCI combination policy might be a way to further enhance persistency for the in-force business and thus boost profitability.

FUTURE ISSUES

We likely will see LTCI benefits integrated with other living benefits on annuity products.

The future of combination annuity/LTCI products will inevitably involve the evolution of more product variations. We likely will see LTCI benefits integrated with other living benefits on annuity products. Further expansion of LTCI riders to single-premium immediate annuity (SPIA) and variable annuity products is likely. Innovation is also expected regarding new structures for these plans to meet the test of insurance and thus achieve optimal tax positioning for the product as well as to meet the needs of the consumer.

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