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North America
Financial Services
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Industry Update

LTC Musings: Prospects Finally Improving

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Sector View:
New: 2-Neutral
Old: 2-Neutral

Investment conclusion

- Long-term-care insurance, which has probably received more attention from investors than any other corner of life insurance but which has been a disappointment in terms of the actual growth of and profits from the business, is about to get a big boost. And if we're right that this highly touted product for America's growing senior population may soon be doing better than it had been, it would be a clear positive for one of our top picks in the life sector – 1-Overweight rated Genworth Financial – as well as for the John Hancock subsidiary of 2-rated Manulife. Both companies are leading writers of long-term-care coverage.

That long-term care may soon be getting a jump start after an extended period of both top- and bottom-line weakness was one of the key take-away points from the spring meeting of the Society of Actuaries. This semi-annual gathering of leading industry CFO's, accountants, consultants, and actuaries ended last week in New Orleans. We attended many of the SOA sessions, which attempted to cover the most pressing accounting and financial issues facing the life insurance industry.

Topping the agenda: When will long-term-care coverage, which is being discussed widely not only by the life insurers themselves but in the general press, deliver on its promise? The consensus of the conference participants: While it's unlikely that LTC coverage sees a major increase in sales or profits in 2005 because significant price increases and the decision by several leading carriers to exit the market have soured both potential customers and agents, other factors should actually help the long-term-care business get back on track. Topping that list: New rules taking effect this year that would actually make long-term-care coverage more affordable by lowering reserving requirements; a trend in the industry to make long-term-care policies far easier to understand than they have been by reverting to an older, simpler policy form called "indemnity coverage"; and a trend by long-term-care carriers to sell shorter benefit periods (and thereby also make the coverage more affordable).

What follows is a more detailed review of the long-term-care sessions at the New Orleans conference – a discussion of why a business that would seem to have so much hope has run aground and why, more importantly, we came away from New Orleans thinking things could soon get better:

Why Long-Term-Care Got in Trouble? Answer: Price Increases, Price Increases, Price Increases.

The overall environment for LTC remains tough. Sales have been flat for a few quarters as most companies in the industry have been rolling out new, more expensive products and have pulled old products. Among the reasons for the higher pricing has been tightening reserving requirements that in turn have reflected regulators' reaction to rate increases on policies in force. And those rate increases, in turn, reflected mispricing of policies at the time they were issued. Dawn Helwig, the long-term-care specialist at consulting actuaries Milliman USA, gave the audience in New Orleans the following illustration. It shows how dramatically actual lapse rates have differed from lapse rates assumed at the time of issue:

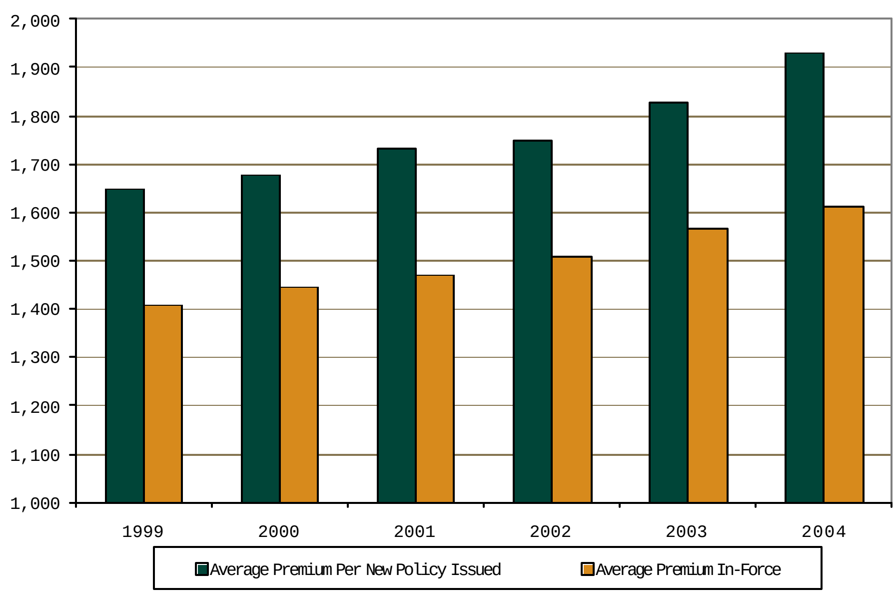
Early Policy Generations - Assumed Lapse Rates			
Policy Year	Company A	Company B	Company C
1	18%	20%	40%
2	14	15	20
3	10	10	8
4	7	8	8
5+	7	6	8

Actual Lapse Rate Experience				
Policy Year	Company D	Company E	Company F	Company G
1	2.00%	4.00%	7.00%	6.50%
2	1.5	2.5	4.2	4.5
3	1	2	2.7	3.5
4	1	1.5	2.1	2.5
5	1	1.5	2	1.5
6+	1	1	1.5	1.5

Source: Milliman, Inc.

Carriers that didn't increase pricing on existing blocks of business are now under pressure to subsidize these underperforming blocks through higher pricing of new products. But most companies did increase rates on existing blocks of business, moves that prompted regulators to respond in two ways – by implementing premium-stability regulation and by increasing stricter reserving requirements on new business written. Specifically, the premium-stabilization regulation required actuaries to certify that their long-term-care rates were adequate. The regulation also imposed severe penalties on carriers in the event of rate increases. The limited ability of carriers to raise prices increased the risk of the product and prompted carriers to price in greater margins for adverse experience, contributing to an upward drift in pricing. And the new statutory reserving standards for Long-Term Care, introduced in 2004, limited the maximum ultimate lapse rate assumption to 2% and explicitly prohibited incorporating provisions for morbidity improvement in assumptions for reserve valuation, despite actual improvements in morbidity over the last 20 years. Both of these assumption requirements – low lapses and no morbidity improvement – resulted in higher reserves and therefore higher LTC rates than in the past. In addition, Stephen Rowley of Gen Re told the group in New Orleans that just as many primary carriers such as AEGON, Transamerica, and Conseco have been exiting the LTC market, reinsurers have also been limiting their exposure to this market and currently there are only a few reinsurers left, a fact that also places upward pressure on LTC pricing. Finally, the low interest rates depress LTC carriers' investment income and create additional pressure on pricing of LTC policies. As a result of all of these factors, new premium per policy issued has been going up, driving the increase in average premium in force, as demonstrated by the following chart:

Average Annual Premium Per Policy, $

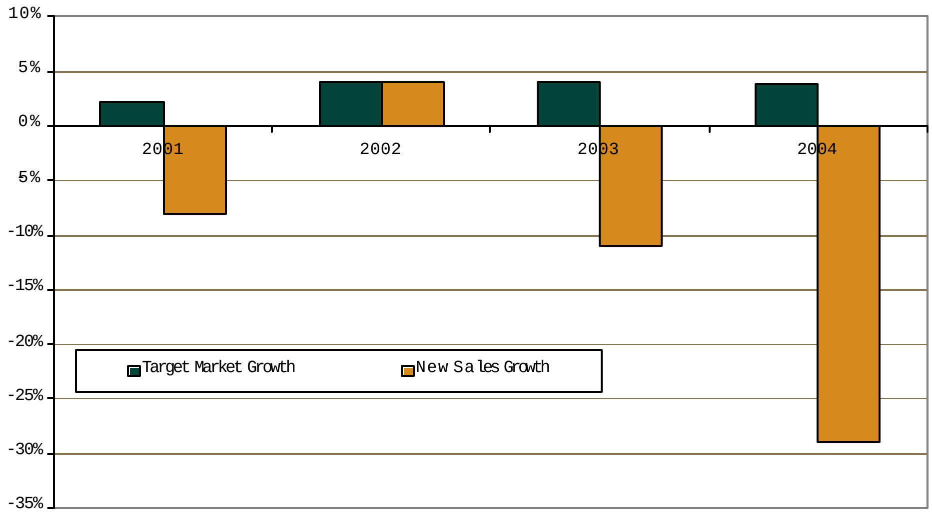


Source: LIMRA 2004 Individual LTC and Medicare Supplement Insurance Survey, Milliman Inc.

This trend in pricing in combination with the exit of several major carriers from the LTC business, has resulted in a major industry-wide decline in sales for the last two years and flatness in sales for the few remaining carriers, such as Genworth and

John Hancock. In other words, despite some very favortable demographics, the long-term-care business remains depressed.

LTC Sales Decline Despite Improving Demographics



Source: LIMRA 2004 Individual LTC and Medicare Supplement Insurance Survey, Census Bureau, Milliman Inc.

In addition to the pricing issue, there is yet another reason why traditional life insurance agents have struggled to sell LTC: It's complicated. According to Ms. Helwig of Milliman as well as a survey in Broker World, an industry trade journal, many products currently on the market include a lengthy laundry list of included and optional benefits:

Expanded issue ages

More Benefit Periods/Elimination Periods options

Alternate plan of care

Care management

Caregiver training

Endorsed group discounts

Bed reservation

Restoration of benefits

Return of Premium on death

Return of Premium w/NFO or Cash Return of Premium

Equipment option

Various inflation options (GPO, 5% compound, 5% simple, other %'s)

Spouse discounts

Joint waivers

Limited pay options

Survivorship

Rate guarantees

Shared pool of money

Monthly Cash Benefit

Ambulance

Drugs

What, then, Came out of New Orleans to Give Us Hope that Things for LTC are Poised to Improve?

Despite this negative overall tone, there are three new developments that we picked up from the discussions in New Orleans that make us more optimistic about the future of Long-Term Care:

Less Stringent RBC Requirements. Once again regulators have moved to change risk-based capital requirements for long-term care. The new RBC requirements in 2005 may give some capital relief to LTC carriers, potentially allowing them to lower prices on their new products to be introduced later in the year. This lower pricing may in turn result in improving sales for the major carriers. The following exhibit from Ms. Helwig's presentation compares the new and the past reserve requirements:

Past RBC:

C2 risk = 5% of claim reserves plus 25% of 1st $50 million of premium and 15% thereafter.

New RBC (effective 2005)

C2 risk = 5% of claim reserves, plus 10% of 1st $50 million of premium and 3% thereafter, plus 25% of 1st $35 million of claims and 8% thereafter.

Making it Simple – Going Back to Indemnity Products Several carriers have recently introduced simpler types of individual long-term care products that are similar to disability insurance. This type of policy, traditionally called indemnity long-term care, used to be dominant in the industry. Then companies reacted to deteriorating profitability of long-term care by shifting to reimbursement-type policies that represent more than 90% of the newly issued policies today. The key difference between the old indemnity policy and the reimbursement policy that's issued by most carriers today is that under the reimbursement approach claims are paid only when a person actually receives care and only as much as is needed to pay for such care, subject to the daily or weekly maximum benefit. In indemnity reinsurance, a claimant qualifies for the payment of maximum benefit regardless of the actual cost or utilization of care – the claimant needs to prove only the loss of two activities of daily living or significant cognitive impairment. This results in much higher loss ratios on indemnity-type policies than reimbursement-type policies, and that's what prompted most long-term care providers to discontinue offering indemnity policies in the first place and to switch to reimbursement policies. But as a result of continuing increases in pricing of reimbursement policies in recent years and of increasing complexity of these policies, several carriers, including MedAmerica and AARP (MetLife), have recently reintroduced an indemnity long—term-care option. These plans are more expensive than reimbursement plans (as much as 50% more expensive, according to Milliman), but they are much simpler and much more flexible than the reimbursement arrangements. According to our industry sources, several carriers are currently either researching current indemnity product offerings in the market or already developing their own products.

It is still early days to conclude that the new generation of indemnity products is good for the industry – after all, it was the indemnity products that were mispriced in the past. In addition, there is an important trade-off between pricing and simplicity of products in long-term care. But such simpler-product introductions could appeal to distributors, potentially opening up new distribution channels for the long-term care industry.

Shortening Benefit Periods to Make LTC Policies More Affordable. There is a trend under way towards shorter benefit periods in long-term care. Other than optional features, there are three most important things that a policyholder must choose at the time of purchase of the long-term care policies: elimination period, daily maximum benefit and benefit period. According to Broker World, the industry's trade journal, 72% of policies sold have 90-day elimination period, meaning that a claimant must wait 90 days after receiving care to file a claim. This out-of-pocket expense during the first few months protects insurance companies and has become standard. The daily maximum benefit has been steadily increasing as the cost of medical care has increased, which has contributed to the increase in average price per policy issued. The only factor left that insurers and distributors can manage to decrease the cost to the policyholder is the benefit period – the maximum period during which an insurance company will continue paying for long-term care after the claim is approved.

About 30% of policies issued today have a lifetime-benefit period – the longest and most expensive. Over the last several years there has been a trend in the industry towards shorter-term benefit periods, such as 3-year and 5-year benefit periods. No surprise, these policies are cheaper and are more affordable to policyholders than contracts that offer benefits for life. This is especially encouraging because according to several recent studies, for most policyholders who actually go on claim, the 5-year benefit would work as well as the lifetime benefit. Given that any decrease in prices without margin compression would be a positive for the industry, this makes us more optimistic about companies like Genworth and Manulife. If we're right, these leaders in the individual LTC industry will be able to charge lower prices for their contracts than would otherwise be the case. Yet neither Genworth nor Manulife should be looking at a margin squeeze since the lower price can be justified by the fact that total claims outlays for 5-year-benefit policies are obviously going to be lower than on policies that pay out for life.

Analyst Certification:

I, Eric N. Berg, CPA, CFA, hereby certify (1) that the views expressed in this research Industry Note accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Industry Note and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Industry Note.

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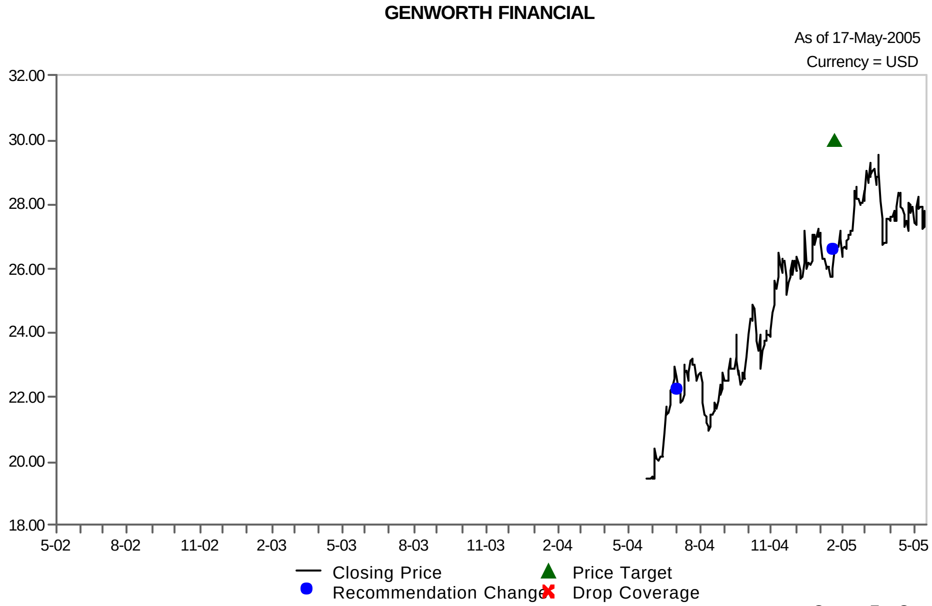
Important Disclosures

Rating and Price Targe t Chart: GNW



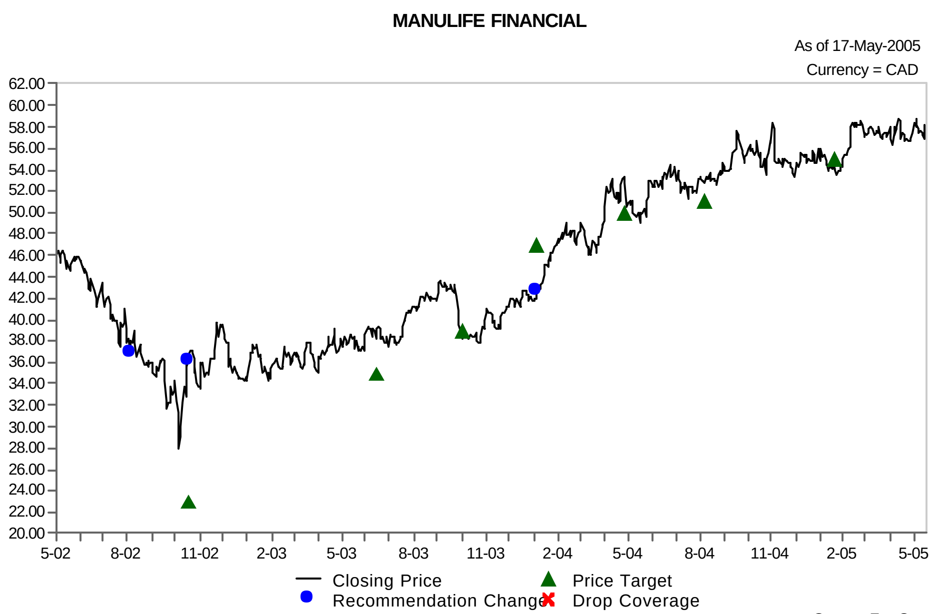
Source: FactSet

Date	Closing Price	Rating	Price Target
19-Jan-05	26.55		30.00
19-Jan-05	26.55	1-Overweight	

Date	Closing Price	Rating	Price Target
06-Jul-04	22.22	2-Equal weight	

FOR EXPLANATION OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART

Rating and Price Target Chart: MFC



Source: FactSet

Date	Closing Price	Rating	Price Target
19-Jan-05	54.41		55.00
06-Aug-04	52.72		51.00
27-Apr-04	52.73		50.00
07-Jan-04	42.63		47.00
07-Jan-04	42.63	2-Equal weight	

Date	Closing Price	Rating	Price Target
03-Oct-03	38.64		39.00
13-Jun-03	38.22		35.00
17-Oct-02	36.18		23.00
17-Oct-02	36.18	3-Underweight	
05-Aug-02	36.93	1-Overweight	

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Related Stocks:	**Disclosures**	**Ticker**	**Price (05/31)**	**Rating**
Genworth Financial	A,D,E,J,K,L,M	GNW	28.99	1-Overweight
Manulife Financial	D,J,K,L,M	MFC	57.67	2-Equal weight

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3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.
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2-Buy - expected to outperform the market by 5-15 percentage points.
3-Market Perform - expected to perform in line with the market, plus or minus 5 percentage points.

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