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GNW - Genworth Financial, Inc. Long Term Care Insurance Investor Call

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OVERVIEW:

GNW provided an update on its long term care insurance business.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Genworth Financial's long-term-care insurance investor call. My name is Shannon, and I will be your coordinator today.

(Operator Instructions)

As a reminder, the conference is being recorded for replay purposes. Also, we ask that you refrain from using cell phones, speaker phones, or headsets during the Q&A portion of today's call.

I would now like to turn the presentation over to Georgette Nicholas, Senior Vice President of Investor Relations. Ms. Nicholas, you may proceed.

Georgette Nicholas - *Genworth Financial, Inc. - SVP of IR*

Thank you, operator. And good morning. We appreciate you joining us for Genworth's long-term-care insurance call. The presentation materials to be used during the call today were posted to our website this morning.

Today, our speakers will be Tom McInerney, Genworth's President and Chief Executive Officer, and Acting President and CEO of our US Life Insurance Division, along with Marty Klein, our Executive Vice President and Chief Financial Officer.

Following our prepared comments, we will open the call up for a question-and-answer period. In the question-and-answer period of the call, we ask that you focus your questions on our long-term-care insurance balance sheet and strategy, given the purpose of today's call.

In addition to Tom and Marty, Amy Corbin, Chief Financial Officer of our US Life Insurance Division, will be available to take your questions.

With regard to forward-looking statements and the use of non-GAAP financial information, during the call this morning we may make various forward-looking statements. Our actual results may differ materially from such statements. We advise you to read the cautionary note regarding forward-looking statements in our earnings release, and the risk factors of our most recent annual report on Form 10-K and our Form 10-Qs as filed with the SEC.

This morning's discussion also includes non-GAAP financial measures that we believe may be meaningful to investors. In our investor materials, non-GAAP measures have been reconciled to GAAP where required, in accordance with SEC rules.

Today's presentation also contains assumptions related to our long-term-care insurance business that are based on actuarial judgment, and in accordance with industry practice, and applicable accounting and regulatory requirements. Many factors can affect these assumptions, and our results depend significantly upon the extent to which our actual experience is consistent with the assumptions we used.

And now I will turn the call over to our CEO, Tom McInerney.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Thanks, Georgette. And good morning, everyone. Thank you for joining us today for this much-anticipated call on our long-term-care insurance business.

Today, I will give some perspectives on the review we completed, along with the key take-aways. I will also discuss our approach to our new product that we began filing in late November for approval to sell in 38 states, with more filings expected by year end. Then Marty will give an overview of the long-term-care balance sheet, and our views on our assumptions and margins, and provide further details on US GAAP loss recognition testing and statutory cash flow testing.

We will also discuss some key sensitivities to the four main assumptions of interest rates, morbidity, mortality, and lapses. We have said repeatedly that we believe we have adequate long-term-care reserves, with a margin for future deterioration. And our presentation today provides support for these conclusions.

As I have told many of you before, when I joined Genworth in January, I was focused on understanding the long-term-care business because of our results and the generally poor LTC results for the industry. Indeed, I came to Genworth with the view that the long-term-care insurance business was a challenged business, and we needed to determine if we should exit the business. However, now that we have completed the very intensive, broad and deep review of the long-term-care insurance business, and developed our three-part LTC strategy, we have determined that long-term-care insurance is a business that we believe can be managed successfully.

A key to managing the Business is staying on top of the performance of the product, and working with regulators to achieve rate increases, as warranted. In that sense, we think long-term-care insurance is more analogous to health insurance than life insurance, since we have the ability to re-rate the product based on differences between our assumptions at pricing and actual experience.

Our long-term-care review considered all important aspects of the Business, and the four key risks that need to be managed. We looked at how we manage our in-force portfolios, and our capabilities of modeling, systems and risk management. We have taken steps to improve all of these areas, including the ongoing implementation of a multi-stage actuarial system conversion. We reviewed and evaluated our processes and approach to implementing rate actions about the older blocks in a more proactive manner than newer blocks. A key focus has been on assessing our reserving process, and the assumptions used to establish both the active and disabled life reserves.

We have run sensitivities to understand how they impact results, and dependencies among the risk factors. We have refined and improved our reserving, underwriting, and risk-management processes, based on analyzing and using our significant data on consumers, underwriting and claims. This information has allowed us to make underwriting changes and product changes to improve the risk profile and returns of our new products going forward. We have approximately 1.1 million lives in-force, and have processed over 190,000 claims to date, which gives us our own credible data.

How we design new products is a key focus for us as we move forward with our opportunity in the long-term-care insurance business. We have recently filed our Privilege Choice, or PC Flex 3.0 product, with a much improved risk profile that has only marginal interest rate and lapse risk, and with significantly less morbidity risk.

Starting with slide 2 in our long-term-care review presentation, I would like to make five points about the in-force margins in our LTC business today.

One, we evaluate our margins using three approaches. Using projections of our best estimate cash flows, and discounting them using projected portfolio rates, the statutory balance sheet margin is approximately $4.6 billion, and the GAAP balance sheet margin is approximately $4 billion. Think of this as the economic margin, and note that both figures are after tax. The primary difference between the two is the amount of assets backing beginning statutory and GAAP liabilities, which Marty will cover later.

Two, Genworth's margins were made solid under various sensitivity assumptions that include lower reinvestment rates, lower lapse rates, less morbidity improvement, and lower projected additional premium resulting from the 2012 rate actions.

Three, we start with the economic balance sheet margins, and then make various required changes to arrive at the actual statutory and GAAP margins. As of September 30, 2013, Genworth's statutory cash flow testing margin, using the methodology that is filed confidentially with the regulators annually, that margin is approximately $2.6 billion after tax and after various provisions for adverse deviations.

Similarly, we complete GAAP loss recognition testing using established GAAP requirements annually. And in aggregate, the GAAP margin is approximately $3 billion pre-tax, as of September 30, 2013. GAAP requires that loss recognition testing be done on a pre-tax basis.

Four, as we discussed in our third-quarter earnings call, long-term-care goodwill is fully recoverable with an excess margin of approximately $400 million, over 100% more than recorded goodwill of $354 million.

And finally, there are two specific items to note that could have some impact on our future results. First, on several purchased blocks of LTC business that we acquired many years ago, which represent about 16% of the net GAAP liabilities, or $2.5 billion, there is a positive but thin loss recognition testing margin of approximately $100 million.

Second, New York has specific statutory cash flow testing reserve requirements that are more conservative than most states. Because of these New-York-specific statutory requirements, we have been holding a $120-million additional reserve in our New York subsidiary over what we would otherwise hold based on our general statutory reserve testing. Our New York business represents approximately 8% of our LTC statutory reserves. Marty will cover the implications of these two issues later in our presentation.

Moving to slide 3, I want to reiterate four significant actions, that we have previously discussed, that Genworth has taken or will take to improve margins, and provide additional detail about these actions. First, Genworth is achieving significant premium rate increases on older policies, to bring the policies closer to breakeven. And the estimated per-annum increases on these policies adds approximately $2.5 billion after tax to the balance sheet margins in our reserve testing.

Second, we have after-tax hedge gains that reside in accumulated other comprehensive income on the GAAP balance sheet, which benefit our GAAP balance sheet margins by $1.6 billion after tax, and this amount will amortize into income over time. Similarly, we have $865 million of after-tax hedge gains on a statutory basis that reside in the interest maintenance reserve, or IMR, on the statutory balance sheet. And the IMR also amortizes into income. Genworth hedged interest rates starting in 2000, and the gains contribute significant margin to our long-term-care reserves.

Three, Genworth has written a significant amount of new business over the last several years with tighter underwriting, higher prices, and higher returns than on the older blocks. Profits from the newer blocks of business more than offset losses or low returns on the older books. And the new business margins strengthen our overall statutory and GAAP margins.

Four, the PC Flex 3.0 product we began filing in late November has projected returns of over 20%, and will also add to both GAAP and statutory margins in the future.

As you can see on slide 4, long-term-care insurance returns are largely dependent on managing four key risk factors: morbidity, mortality, investment returns, and lapse rates. As we have discussed on prior calls, the older-generation blocks have experienced significant losses, primarily due to actual lapse experience that has been worse than pricing expectations. Even with the benefit of the hedging we have done since 2000, the interest rate environment has adversely impacted returns in LTC.

We seek to manage the four risk factors in a variety of ways. First, Genworth and its predecessor companies have been issuing LTC policies since 1974, almost 40 years. We leverage our extensive experience in claims and underwriting with over 190,000 claims processed to make changes to our underlying morbidity, mortality and lapse assumptions. Experience continues to emerge, which, in turn, is used to price our new product offerings. For instance, our newest product, PC Flex 3.0, will have ultimate lapse assumptions of 0.5%, and annual morbidity improvements in line with our experience.

Second, we have also made changes to the product design over time. Last year, we discontinued offering policies with lifetime benefits, as those policies perform worse than policies with non-lifetime benefits, despite the difference in premium rates. We further reduced the maximum benefit period offered on our new PC Flex 3.0 product to a maximum benefit of five years, which will reduce the ultimate morbidity exposure.

Third, as I already mentioned, over the years, Genworth has successfully implemented tighter underwriting standards, which has benefited our risk profile. Slide 4 shows some of the changes in our underwriting criteria over the last 20 years. Policies issued today require additional cognitive testing, and require blood and lab underwriting requirements to better assess certain health conditions, such as diabetes, that can impact the morbidity of our insureds in future years.

Fourth, hedging has been an important tool to help manage investment returns, given the long duration of 25 to 30 years on LTC products. With the new PC Flex 3.0 product, we have set the pricing ultimate interest rate at a low rate, 3.25%, that we believe negates the need for hedging.

And finally, we are seeking, and will continue to seek, premium rate increases on both old-generation and new-generation policies where actual experience has either deviated or is projected to deviate from original pricing assumptions. As I said earlier, the major structural difference that I believe will make the long-term-care insurance business a better business going forward is this concept of annually reviewing experience compared to assumptions to set up pricing, and pursuing premium increases as warranted.

With that, I will turn the presentation over to Marty to discuss the long-term-care insurance balance sheet assumptions and margins in more detail.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Thanks, Tom. And good morning, everyone. Let me start on slide 5 where we have provided a few excerpts from the statutory and GAAP balance sheets that we think are meaningful to investors.

We hold two main types of reserves: active life reserves, or liability for future policy benefits; and disabled life reserves, or the liability for policy and contract claims. Active life reserves represent the excess of the present value of expected future benefits over the present value of the portion of gross premiums determined at issue required to fund expected benefits. The difference between the gross premium and this valuation premium funds both expected profits and expenses.

The assumptions underlying these reserves are slightly different for GAAP and statutory reporting requirements, but are generally a best estimate of cash flows, with a provision for adverse deviation, with more conservatism built into the statutory reserves. For both stat and GAAP, these assumptions are locked in, in the year of policy issuance.

Disabled life reserves are held for policies on claim, and are established using best estimates for both GAAP and statutory for factors such as morbidity, mortality, recovery, and claims continuance. Disabled life reserves are released as claims are paid, or in the event a claim terminates as a result of recovery, death, or exhaustion of benefits. In general, the assumptions underlying disabled life reserves are updated periodically.

The statutory interest maintenance reserve primarily relates to the statutory gains from our hedging program that have been realized over time. This amount is different than the hedge gains in the GAAP accumulated other comprehensive income because of accounting treatment related to Genworth Life Insurance Company's reinsurance of 50% of the long-term-care insurance portfolio with our Bermuda subsidiary, Brookfield Life and Annuity Insurance Company. Under Bermuda accounting, there is no interest maintenance reserve balance, and so gains from hedges accrue immediately to equity. Balances in the IMR are amortized into statutory income in future years, and hedge gains in AOCI amortize into GAAP operating income in future years.

Turning to slide 6, today we are going to present three different methodologies for calculating LTC margins. All three of these approaches are based on policies in force, and do not include the impact of new business. Going forward, our new PC Flex 3.0 product is priced with a 20% return, and will benefit margins in the future as new business is added.

First, the balance sheet margin is calculated on an after-tax basis, and uses projected premiums, claims costs, taxes and other expenses based on our best estimate of mortality, morbidity and lapses. We discount future earnings for this calculation at the after-tax projected earned rate, or 3.25% to 3.6% for this analysis, which is the same for statutory and GAAP.

Second, we also are required to file statutory cash flow testing results annually. Statutory cash flow testing is performed separately for each legal entity on an after-tax basis, and utilizes our best assumptions, adjusted for provisions for adverse deviation.

Finally, we perform GAAP loss recognition testing at least annually. GAAP loss recognition testing is done on a pre-tax basis. Consistent with our GAAP practice, the discount rate is static, based on the portfolio of assets supporting the net GAAP liability as of the calculation date -- 5.91% for this analysis -- and therefore, excludes the benefits of hedge gains that are not currently amortizing.

As the assets for loss recognition testing are capped at reserves less DAC and PVFP, it also does not include earnings on the terminated swaps that have been reinvested. The after-tax balance sheet margins, based on the statutory GAAP balance sheets, are laid out on slide 7. The starting point for the calculation is invested assets as of September 30, 2013, on both the statutory and GAAP basis, which is shown on the top of slide 7, based on the details shown on slide 5. When there is a positive margin using these assets, then no assets, other than those backing policyholder liabilities, are required to pay future claims.

The present value of future premiums, claims, and expenses and taxes, are projected based on a combination of two factors. First, we utilize assumptions based on our experience, as evidenced in our actual financial results, such as lapse, morbidity, in-force assets and in-force rate action approvals. Second, market-based perspectives and outlooks are reflected for the potential future outcomes such as reinvestment rates from forward curves, and expectations of future in-force rate action premium approvals.

Based on these factors, we have set our assumptions for ultimate lapses at approximately 0.7%, 10-year treasury rates ultimately reaching 4.7% by 2023, morbidity with 10 years of future improvement of 1.6%, and mortality with 10 years of future improvement of 1.0%. Our assumption for in-force rate increases is that the annual premiums will increase by $280 million through 2017.

The discount rate utilized in the balance sheet margins is the same for both statutory and GAAP, and is the expected after-tax portfolio earned rate, which reflects our assumption for future treasury rates, plus a credit spread based on our investment strategy, and a portfolio rate on our existing assets. This discount rate on an after-tax basis currently ranges from 3.25% to 3.6%. Using these assumptions, the after-tax balance sheet margins for both statutory and GAAP are solid at approximately $4.6 billion and approximately $4.0 billion, respectively, as shown on slide 7.

Long-term care is a long-duration product, and movements in key assumptions can impact performance over time. With that as a backdrop, we have provided sensitivities on key assumptions that are roughly 1 standard deviation around our estimates.

Referring to slide 8, the lapse sensitivity, or sensitivity A, further accelerates the decline in the actual lapse experience we have seen by reducing lapse rates by 25 basis points from the assumption of 0.7% to less than 0.5%, on average. The morbidity and mortality improvement sensitivity, or sensitivity B, assumes that the medical progress seen over the last 20 years slows down. Our assumption assumes 10 years of morbidity and mortality improvement averaging 1.6% and 1%, respectively, per year. And in sensitivity B, we reduced the annual improvement horizon to five years. We will show you our historical morbidity improvement trends on a later slide.

The in-force rate action sensitivity, or sensitivity C, assumes that the premium rate increase will only reach $250 million, as requests in remaining states where we are still awaiting a decision, or in states where we will file for additional rate increases, are not approved at the rate we are currently experiencing.

The interest rate sensitivity, or sensitivity D, takes the view that the US economic recovery is further delayed, therefore, keeping treasury rates low from further fed actions, with the 10-year ultimate treasury rate 110 basis points lower than our initial estimates. We will explain this further on slide 12.

We have also provided a flat interest rate sensitivity, sensitivity E, that holds treasury rates flat with the 10-year treasury rate at approximately 2.5% through the projection period.

While we believe these scenarios are not likely, our statutory and GAAP margins remain solid under each of these individual scenarios, as shown on slide 8. We have also provided a sensitivity that assumes sensitivities A through D occur at the same time. While we view this sensitivity as quite unlikely, in this scenario our statutory margin would remain positive at approximately $1.8 billion, while our GAAP margin would be approximately $1.2 billion.

Moving to slide 9, I will provide some perspectives on our annual statutory cash flow testing process. Statutory cash flow testing is required by state regulators, and required testing assumptions are generally more conservative for all key assumptions. As previously mentioned, the testing is done separately for each statutory filing company.

Starting with our balance sheet margin using our assumptions of approximately $4.6 billion, we make four adjustments from the balance sheet margin to provide provisions for adverse deviation to get to the cash flow testing basis. First, we use interest rates that are lower than the interest rate assumption used in the balance sheet margins.

Second, ultimate lapse rates are reduced by 25 basis points. Third, we limited the annual morbidity and mortality improvement to 5 years, rather than 10 years. And finally, we assume that annual premiums from the in-force rate actions are $30 million less, or approximately $250 million, through 2017, versus the assumption of approximately $280 million.

The statutory cash flow testing margin for our long-term-care business in the US life insurance companies, and Brookfield Life and Annuity Insurance Company, after reflecting these four adjustments, is approximately $2.6 billion, after tax. As a reminder, cash flow testing results that are filed with the regulators are done based on year-end data. And the PADs as of year-end 2013 may change from the September 30 PADS. But we believe the results presented here will be in line with the full-year 2013 results in aggregate.

As Tom mentioned, New York has specific statutory cash flow testing reserve requirements that are generally more conservative than other states. In addition to the other interest rate scenarios we evaluate, New York requires us to complete a special test with extra conservatism and a level interest rate scenario. As a result of this special test, we recorded at year-end 2012, and continue to hold, an additional statutory asset adequacy reserve in New York of $120 million.

Moving to GAAP loss recognition testing, or LRT, on slide 10, please note that GAAP loss recognition testing is done at least annually, and is performed using a gross premium valuation, where cash flows are discounted at the current portfolio earned rate, currently 5.91%, and only reflects hedge gains that are currently amortizing. That is, it does not reflect hedge gains which begin amortizing in future years.

I would like to highlight the five GAAP methodology adjustments from the balance sheet approach to arrive at the official GAAP loss recognition testing margins shown on page 10. First, LRT is done on a pre-tax basis, so assumed cumulative taxes of $1.4 billion on a present value basis are added back. Second, for LRT, while the portfolio rate we discount at reflects the benefit of the gains from terminated swaps, the actual asset proceeds from these transactions are considered capital, and cannot be used in this liability-based test. Therefore, we subtract the $2.5 billion of pre-tax hedge gains.

Third, the margin in loss recognition testing are discounted on a pre-tax basis, and not on an after-tax basis, as is the case in the balance sheet margin. This further reduces the GAAP LRT margin by $1.5 billion.

Next, an adjustment of $1.3 billion is added for the difference in reinvestment rates over the projection period. In LRT, we utilize a static reinvestment rate assumption and, therefore, a static discount rate. And finally, in LRT, certain allocated corporate expenses and other items are not included in the projections, the present value of which is $300 million.

After making these five GAAP methodology adjustments, the actual LRT margin in aggregate is approximately $3 billion, as shown on slide 10. As I mentioned, we currently use a static discount rate for LRT. If we were to apply a more dynamic reinvestment assumption based on sensitivity D, which I discussed earlier, the LRT margin would reduce to approximately $2.0 billion in aggregate.

Finally, we have two LTC blocks that are tested separately for GAAP LRT. The purchase block, or P GAAP block, and all other policies, or H GAAP block. The P GAAP block is about 16%, or $2.5 billion of the $15.9 billion of total long-term-care net GAAP liabilities. The P GAAP block has a positive LRT margin of approximately $100 million.

Given this relatively thin margin, which we have disclosed annually in our Form 10-K, we wanted to provide investors with a sensitivity highlighting the potential for a PVFP and reserve shortfall in the future. If we were to assume a lower reinvestment rate similar to the flat interest rate sensitivity, or sensitivity E, provided earlier, and lapses lower than our estimate by 25 basis points, the PVFP writeoff or reserve shortfall would be approximately $40 million pre-tax. It is important to note that this block is much less sensitive to interest rates given its age and, therefore, lower reinvestment risk.

Beginning on slide 11, I want to provide some additional perspectives on our assumptions, starting with assumed, expected and additional premiums per annum from the rate action announced in 2012. Our assumption for the additional premiums from the rate action is approximately $280 million, and is made up of three parts. First, we continue to make good progress on the premium rate increase approvals on the three older generations, or series of products written from 1974 through 2001, and then one series of new-generation policies written from 2001 through 2007. As of September 30, we've received approvals representing approximately $155 million of annual premium increases from 31 states.

Second, we are awaiting decisions from 20 states where our expectation is that we will receive approvals representing approximately $50 million of annual premium increases. And finally, some states did not give us full approval on our initial rate action filing, and we will be filing for additional increases in the future in those states, and expect that these additional filings will result in an additional $75 million when fully implemented. Given this progress, we are revising our expected range of annual premium increases to $250 million to $300 million, from $200 million to $300 million when fully implemented.

On slide 12, we provide more detail on our investment income assumptions. In setting our assumption for future treasury rates, we utilize the forward treasury curve as of September 30, and assumed an ultimate 10-year treasury rate of 4.7%, starting in 2023. I would note that the September 30 forward curve has the 10-year treasury rate increasing to approximately 5.5% in 2034 and in 2035, and then falling from there. Our lower interest rate scenario sets the ultimate 10-year treasury rate at 110 basis points less than this assumption.

Moving to the morbidity improvements assumption on slide 13, we utilize our extensive experience when setting assumptions for morbidity. Our experience shows a consistent trend of improvement in claim incidence rates with each successive generation of underwriting standards. Additionally, the amount of annual improvement within each generation varies by policy duration, issue year, and issue age.

We have provided two examples of morbidity improvement for issue ages of 60 to 70, and standard health that demonstrates the morbidity improvement for two product forms. We also see similar trends for our other product forms. Our assumption for morbidity of 1.6% annual improvements per year for 10 years represents a blended average across all products.

Turning to our last assumption on slide 14, historical lapse experience has been decreasing by policy duration, and has been impacted by factors such as economic conditions, the perceived value to our policy holders of their in-force policies, and the in-force premium rate actions. Our ultimate lapse rate assumption of 0.7% is based upon our actual historical experience.

With roughly 40 years of experience in this business, we believe we have performed our three tests using reasonable assumptions. The alternative sensitivities we have shown indicate how margins would perform under more conservative assumptions.

With that, I will turn it back over to Tom for some closing comments.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Thanks, Marty. As outlined on slide 15, we believe our margins in the LTC business are solid in aggregate, and perform well under key sensitivities. Actions we have taken, such as pursuing significant in-force rate increases, hedging cash flows, and tightening underwriting, continue to benefit GAAP and statutory margins. In addition, profitable new business that we are writing today will add to statutory and GAAP margins in the future.

But the most important point I want you to take away from today's presentation is that long-term-care insurance must be managed proactively with annual reviews of experience and the pursuit of smaller, more manageable rate actions, as warranted, somewhat similar to how health insurance products are managed. In hindsight, I think the entire long-term-care industry would have been better off if it had filed for smaller, more frequent rate increases on long-term-care insurance policies, as experience differed from initial assumptions. This would have alleviated the need to deal with current, larger increases.

We believe long-term-care insurance is an important product for American baby boomers and seniors. When we meet with governors, insurance commissioners, and other state regulators, we discuss the following key points.

One, we should be aligned in our objectives to have a robust private insurance market for long-term care. Many individuals remain unaware that Medicare does not generally cover long-term-care needs.

Several companies have already left the LTC market. And if the private market goes away entirely, many Americans will ultimately need care through state Medicaid plans. These Medicaid plans are already paying 25% to 50% of their budgets for long-term-care claims. In 15 to 20 years, when the 76 million baby boomers reach the ages where they're likely to need long-term-care insurance, the stress on Medicaid budgets will be enormous, and even more strained than they are today. I can say with certainty that state public policy makers are very concerned about this issue.

Two, we believe there is an opportunity to educate consumers about the need to buy long-term care, help states with their Medicaid budgets, and service the long-term-care needs of consumers if the remaining private industry carriers, and the state and federal governments, work together.

Three, we are working with all of the states on the three-part strategy for Genworth to manage the long-term-care insurance business. First, seek significant premium rate increases on the older generation of long-term-care insurance blocks written before 2002 to bring them closer to a break-even point over time, and reduce the strain on earnings and capital. Second, seek prompt approval of new products that are more tightly underwritten with appropriately priced benefits using more conservative assumptions. And third, file smaller rate increases on newer blocks, as needed, to bring them back to original pricing.

We are asking the regulators to approve rate actions by focusing on the projected loss ratio, versus the actual loss ratio based on experience at the time of filing. As you know, in September, we began filing for premium increases of 6% to 13% on certain policies written between 2003 and 2012, and we have received approvals from three states already.

We have worked hard to provide information on our long-term-care insurance approach, assumptions and sensitivities to show you why we are even more confident with our GAAP and statutory long-term-care insurance reserves. We anticipate updating you on our margins annually, as we complete the testing.

I am also confident that all of the actions we have taken, and our new strategic approach, will enable Genworth to remain a leader in the long-term-care insurance industry, and put us in a position to take advantage of the opportunity before us to make long-term-care insurance a very strong business for Genworth.

And now we look forward to answering your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions.)

Suneet Kamath of UBS.

Suneet Kamath - *UBS - Analyst*

Thanks and good morning. Just a couple of questions about the slides. First, the $250 million to $300 million of additional after-tax margin from new business, just wanted to be clear, that's not embedded in the margin numbers that you've given us?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

That's correct. The margins are only at the point in time -- so, in this case, 9/30/2013 -- and the in-force business as of that date. It doesn't consider the new business. I think what we're saying is, going forward, we would project, as we do future testing, that the new business would add, based on I think sales assumption of $175 million, would add that amount per year going forward. But that is not taking into account the current margins.

Suneet Kamath - *UBS - Analyst*

Got it. Okay. And then on the price increases, the best estimate of $280 million, and I think your low case is $250 million, there is not a huge difference between those two numbers. So, if we look at those sensitivities, if we wanted to gauge how the reserves might change, or the margin might change, if we dial back, or dial down the $250 million, can we use some -- is it a linear relationship? And if we wanted to take it down to, say, $200 million or something, just to stress it a little bit more, would it be a linear approach?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

I would say we provide that sensitivity on slide, whatever that is, 8. And if that difference of the $30 million is about $0.2 billion, I would say as a general rule of thumb, it is probably okay to do that. But, obviously, as you go down, it will change and it would ultimately increase somewhat. But yes, I think you can use that as a general rule of thumb.

Suneet Kamath - *UBS - Analyst*

Okay. And then maybe just last question. On slide 22, you show us a lot of detail on the different blocks that you have in terms of the earned rate and the lapse rate assumptions. Can we assume that on the old blocks that the lapse rate assumptions of 5% to 5.5% have now been taken down to that 0.7%? Is that what you mean by ultimate lapse rate? Or are the underlying assumptions still at this 5% to 5.5%?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Steve, it is Marty. No, I think for the margin testing we're presenting this morning, those are the assumptions that we're using as we're projecting out the margins. So, we're assuming 0.7%. The numbers that show on page 22 really reflect the original pricing assumptions.

Suneet Kamath - *UBS - Analyst*

Okay. So everything is at the new levels, right? -- in terms of lapsed --?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Right. Margins are shown at the assumptions that we presented this morning, which are the current best estimates, along with, in some cases, some sensitivity.

Suneet Kamath - *UBS - Analyst*

Understood. And maybe just one -- I appreciate all of the detail. I don't know if you guys have provided in the past, of the various vintages, when you talked about the price increases that you have gotten, how those price increases are allocated across these vintages.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

So, basically, I think what we've said, is if you look at that slide 22, what we call the old block, the pre-PCS, PCS1 and 2, and obviously you can see the original pricing assumptions were significantly higher than what the reality has been. So, most of the price increase need is for those old blocks. So, in general, we're asking for more than 50%. Obviously we don't necessarily think we will get all of those up front. They may be spread out over time. But that's where the bulk of the $280 million will come from. In addition, on Choice 1, which is part of the newer block, as we define it, but it is an older version of the newer block. So, we have used in quarterly calls that terminology. It really was the Choice 1 block. So, on that, we're filing for rate increases of a little above 25%. Again, that is not to say we will get that. But, in all cases, on the three older blocks and on Choice 1, what we filed for, if we receive that -- and we file per block -- that would bring us closer to break even on the three older blocks, and on Choice 1, it would get us closer to the original pricing assumption. And that's what our goal is, is to get the older blocks closer to break even. And then for Choice 1 and the newer books, to the extent we need to file rate increases, that's where we'd do the smaller ones more frequently, so that we try to get those blocks back to the original pricing assumptions and the original profitability targets going forward. So that is the strategy.

Suneet Kamath - *UBS - Analyst*

Got it. Okay. Thanks very much.

Operator

Jeff Schuman of KBW.

Jeff Schuman - *Keefe, Bruyette & Woods - Analyst*

Thanks, good morning. I wanted to get a little better understanding around the morbidity and mortality improvement assumptions. First of all, one clarification. Is mortality improvement a good guy or a bad guy?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Mortality improvement is a bad guy because the longer people live, in the case of long term care, it would be viewed as, quote-unquote, a bad guy, because there is more people around later to claim. In life insurance, it is different.

Jeff Schuman - *Keefe, Bruyette & Woods - Analyst*

That's what I always thought but then I was curious that, when you stressed the assumption, you reduced the mortality improvement from 10 years to 5 years. That is actually a less conservative assumption?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

I think the improvement in morbidity and mortality offset a little bit, to some extent. We do think, based on our experience, there is a very high correlation with all of the analysis we have done, and I think others have done. So there is a very high correlation, that I think does seem to make some logical sense. But morbidity improvements and mortality improvements do work in little bit different directions. Morbidity improvement obviously is a favorable aspect, and mortality improvement is not favorable.

Jeff Schuman - *Keefe, Bruyette & Woods - Analyst*

And can you give us just a little more comfort on the morbidity piece of it? It sounds like some of the historical improvement has been driven by underwriting changes you made historically. But as we think about that in the future, is there some risk that you don't get the pick-up from underwriting changes? Or is there some risk that if cancer and heart disease treatment improves more than Alzheimer's that it could actually go the other way?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, I think part of this is, as we have done our analysis, and we give you some sense for that in one of the slides, we do think morbidity improvement has been around for quite some time. And we've actually had a study that we've done, reviewed by outside parties, which corroborate it. And it is based on a lot of credible data that we have gotten from our own experience. I think that part of why we wanted to show sensitivities is, while we think in our best estimate that it is, assuming that 10 years is appropriate, we also wanted to show the sensitivity for 5 years, because we think that helps provide some investors some idea of the sensitivity in our margins of that assumption. Because, as you pointed out, it is very hard to predict over the very long haul how that's going to really work.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

And Jeff, I tried to emphasize in my remarks, but for everybody on the call, we have to remember, going forward, we are going to manage this business differently. We don't have to get everything correct today on morbidity or mortality or lapse or interest rate assumptions. We know they will change over time. And morbidity could go against us. Mortality could go against us. Same with lapses in interest rates. Although we think on the new product that is unlikely. But we can correct for that by seeking these more frequent proactive rate increases. So, unlike life insurance, which all of you are more familiar with because you follow that more, this product should be viewed as a health insurance product. And just like what other health insurers do, to the extent that trends go in the wrong direction, we need to seek rate increases to bring those back to pricing assumptions.

And that's the message that I'm giving to regulators -- is, in order to make a competitive private market, you have to manage this business, and you have to regulate the business, in a way where you recognize that no company can predict interest rates, lapse rates, morbidity, mortality for 30 years. And again, as I said, in hindsight, I think the industry would have been much better off if they had managed the business more like a health insurance business versus life, and saw regular price increases of more modest amounts that are easier for regulators to approve, and more comfortable for consumers. And if we had done that in the past, I think long-term care would have been a much better performing industry. But going forward, I think the major change, and I think Genworth is going to lead on this, will be to move to a process that both the industry, as well as regulators, get more comfortable with the fact that you have to allow for the re-rating annually to take into account what may happen over the 25-, 30-year duration of the policy.

Jeff Schuman - *Keefe, Bruyette & Woods - Analyst*

Thanks for the answers and thanks very much for doing the call.

Operator

Ryan Krueger of Dowling & Partners.

Ryan Krueger - *Dowling & Partners Securities - Analyst*

Good morning. Thanks for all of the additional disclosure. I had a few clarifications. One, the statutory cash flow testing margin presented of $2.6 billion, just wanted to make sure, is that for long-term care on a standalone basis or does that incorporate any other product lines?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

We have it on a standalone basis.

Ryan Krueger - *Dowling & Partners Securities - Analyst*

Okay, standalone. And how did you treat the reserves that are ceded to Bermuda? Did you use the US statutory methodology for those reserves?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, so the $2.6 billion represents across all of the legal entities where we have long-term care, which includes the Bermuda company, BLAIC -- Brookfield Life and Annuity Insurance Company -- as well as Genworth Life Insurance Company and Genworth Life Insurance Company New York. It really reflects all three of those. The analysis is done separately. In Brookfield, it works -- or BLAIC, I should say -- very much like it does in the statutory entities, with one exception. And that exception is that the interest maintenance reserve is not reflected in margin in BLAIC because that is already reflected in equity because there is no concept in Bermuda accounting of an interest maintenance reserve. So, actually the interest maintenance reserve we have in our US statutory entities of about $0.9 billion, there is no such concept in BLAIC and so that does not benefit the margins in BLAIC. I would say that one of the things we have been looking at very seriously is a potential repatriation of the long-term care business in BLAIC. We provided some disclosure on our previous calls about how what that would look like. And, again, given the amount of capital we hold currently in BLAIC, as well as the amount of capital we hold in our US life companies, we really don't think there would be a significant impact to RBC ratios if we did the repatriation.

Ryan Krueger - *Dowling & Partners Securities - Analyst*

Okay. And I assume, also, if you did the repatriation essentially none of the announcements you have provided us today would really change either, it sounds like.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Right, there would be no impact at all on the analysis because it really is included in the analysis. So the repatriation would have no effect on the margins.

Ryan Krueger - *Dowling & Partners Securities - Analyst*

Okay, thanks. And one last one, do you have an update on the GAAP allocated to equity for long-term care? I think you disclosed it a few years ago but not recently.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, it is not something that we have been disclosing. Obviously we get a lot of requests for disclosure and that is something we might give consideration to. But, no, we don't have an update on that this morning.

Ryan Krueger - *Dowling & Partners Securities - Analyst*

Okay, thank you.

Operator

Sean Dargan of Macquarie.

Sean Dargan - *Macquarie Research - Analyst*

Thank you. If we look to slide 8, and in column F, instead of sensitivities A through D, if we replaced D with E, what would that number look like? So, in other words, just assume that the 10-year treasury rate remains at 2.5%.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Okay. I would ballpark it as it would have a comparable impact to what it shows by itself. I don't know if it would be exactly equal to that but it would give you a rough estimate of it.

Sean Dargan - *Macquarie Research - Analyst*

All right, thanks. And then on slide 22, which I think is very helpful, where you show the evolution of the products by vintage, when we think of new claims, how far after a policy is written on average do you receive a claim?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Sean, the average age at policy issuance is 58, and the average age at claim is 79.

Sean Dargan - *Macquarie Research - Analyst*

Okay. And just one last question. When you put through these fairly significant pricing increases, why aren't you assuming some sort of shock lapse? Shouldn't lapsation pick up for a year or two as policyholders decide that they don't want to pay the additional premium?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Sean, as we disclosed on the last call, obviously we have quite a bit of experience now with what policyholders are actually doing when they see these, or receive these large rate increases. Just to repeat, 83% are accepting the full rate increase. And I think the reason that four out of 4 are doing that is because, even with the rate increase, these are very valuable policies. And, remember, with a rate increase we are only getting those policies closer to break-even. So it is still a good deal. And I think they and whoever is advising them are making good decisions there. About 12% -- because we allow anyone to take a reduced benefit so they don't have to pay any increase, or they can take some reduced benefit and pay a smaller increase -- about 12% are doing that. And then the balance, which is 5%, are taking the nonforfeiture option or lapsing. I think it is less than 1% lapsing. But even for those that are lapsing, we are giving them the nonforfeiture option. And what that means, fairly simply, is whatever premiums they have paid to date, less any claims they have made, or payments we have made on claims, they get the value of those premiums, so they don't lose that. And one of my compromises with regulators has been, they have been worried about the fact that there could be a lot of lapses and people would forfeit the premiums they paid. So, while in many cases people would have qualified for that nonforfeiture benefit, we have agreed with regulators that we will give that to everybody. So, our actual experience is that when you look at actual lapses you don't see the shock lapses that you might expect. And I think the reason for that is pretty straightforward and simple, in that, despite the percentage increase, the actual amounts are such that people would much rather pay an extra $50 or $100 a month to keep, in most case, on these old policies, an unlimited benefit. So it is still a very attractive policy for them including the full rate increase.

Sean Dargan - *Macquarie Research - Analyst*

Got it. Thank you.

Operator

Thomas Gallagher of Credit Suisse.

Thomas Gallagher - *Credit Suisse - Analyst*

Good morning. I had a first question on page 13. I'm a little confused by this. Should I take this to mean that your morbidity experience has been steadily improving over the last several years? Or is this new generations of products have had better morbidity experience than the older generation? Because from listening to everything I've heard in the industry, claim trends and morbidity experience has worsened as of the last several years. But just wanted some clarification on that.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

No, actually, the morbidity improvement we have seen goes way back. In fact, if you look at page 13, we really compare in the left side chart business written back in 1995 and 1996, and then a more recent generation of that, 1997 to 1998, and then do a comparable analysis with more recent vintages. But, no, we have certainly seen that along the way. I think that what we see is that, while there is an improvement in morbidity incidence rates, I think that some people who think about long-term care sometimes think about increasing loss ratios increasing claims and confuse the two. The reason that there is increased claims is really because of persistency or lapse rates which have been much lower than what most companies have originally priced for. So, because of those lower actual lapse rates, there are more people around, more policies around in later durations that then go unclaimed. And that is really the reason for higher claims. It is not really morbidity incidence rates.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

I want to go back, just one more point, to go back to the previous question from Sean. If we didn't take public policy and fairness issues into account, Sean, I would say that the best outcome for us would be everybody lapses on these old policies. And so, again, because if there is a concern that you have or other investors have, or analysts, that shock lapses -- in this case, shock lapses would be good. However, from a regulatory and public policy perspective, we think that it is very important that the policyholders that have been with us for a long time and are paying premiums, that we keep most of them as policyholders because of the value in the policies. So, I think it is working out very well. And I think the regulators are quite pleased that despite these very large increases, most policyholders are keeping their policies. And I think they also feel maybe these rate increases are not so bad from a political perspective, or in thinking about consumers, because most consumers are accepting them. So I think that has given the regulators additional comfort that what we're doing, while certainly policyholders don't like rate increases, it still ends up being a fair deal after the fact. But I wouldn't want you to go away with that there is a big risk to the extent that things change, and we have more lapses.

Thomas Gallagher - *Credit Suisse - Analyst*

And Marty, I wanted to come back to you on your response. So, if I understand it correctly, the incidence per unit has actually been getting better, but there is just more units outstanding, and that's why you've seen unfavorable claims trends. Is that the right way to think about it?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

I think that is the right way to think about it, yes, Tom.

Thomas Gallagher - *Credit Suisse - Analyst*

So, my question is, I thought regulators would only grant re-rates on the basis of adverse morbidity. And that they wouldn't grant re-rates on the basis of mis-estimates on interest rates or lapsation. So, if in fact your morbidity is getting better -- and maybe I'm misunderstanding that but I'm been told that by some other companies -- if actually your morbidity is getting better, how are you able to get the re-rates you're getting?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Tom, I have met with many regulators, commissioners, governors, et cetera. And what we're explaining to them is that on these old policies, all of the assumptions turned out to be not accurate as things played out. And therefore, actuarially, in order to get these policies closer to break-even, we need the rate increases we're filing for. And I think we're doing well there. And I do think, and I said this in my remarks, and this is based on meeting with a lot of governors, a lot of insurance commissioners and other regulators, a lot of head of Medicaid programs in the states, that with other LTC carriers leaving the market, that we have lost about 30% of the capacity. Our market share is 35%. So, if we were to leave, that creates a reasonable shrinkage in the overall market. And I do think that regulators do recognize that if they want to keep an active competitive private market, they have to step back and consider looking at long-term care and the increases from a different perspective. And I think generally that is something that they're prepared to do. There is quite a bit going on at the NAIC and various task forces of the NAIC around long-term care to try to move forward on a basis that works well for consumers and policyholders, is acceptable and prudent in terms of what the carriers are doing, the risks that they're taking, and ultimately the regulators feel comfortable that balancing all of the things they have to balance, that it is coming out in a good place. So, I do think that regulators do understand that, particularly on the old blocks, the aggregate of the original pricing assumptions versus the reality of what actually has happened, there needs to be an adjustment on the rate, the premium rates, in order to bring those more in line. And particularly for us, we're just asking that we bring those closer to break-even over time.

Thomas Gallagher - *Credit Suisse - Analyst*

Got it. And then my last question is, have you all looked at incidence trends at different age cohorts? For instance -- and I see your slide 13, it says you have seen improvement across all policy durations, issue year and issue age -- but I'm just curious if you have seen in overall how we should be thinking about the loss ratio. Has that looked meaningfully different, let's say, for anything younger than age 80 and over age 80? And the reason I ask is, and I think a confusing aspect of this is the incidence of Alzheimer's and dementia and what that means for the 80 and over book, if we should be thinking about that?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, I think we do see generally morbidity improvement largely across the board. It does vary to some extent by age and we certainly do look at that. We haven't really disclosed that this morning. I think the other thing that we see is that in addition to people going on claim -- I'm sorry, I'm trying to read something here, I apologize. I would say that we have very credible experience on 190,000 claims that we look at. And I think that experience is pretty credible all the way up to the upper ages, well into the late 80s or early 90s. And certainly the incidence of Alzheimer's is something we are watching very closely. I would say that 50% of our claims are for what we call cognitive disorders. So it certainly is a big issue. And it is also why we track it closely. And, to Tom's earlier point, we want to make sure that as we're looking at our business, and we are going to do this on a much more frequent basis, we want to track all of those things, and apply for rate increases as we see experience deviating from a pricing assumption. But certainly with 50% of the incidence coming from cognitive disorders, it is something that we watch very closely.

Thomas Gallagher - *Credit Suisse - Analyst*

And -- sorry, just one more -- just lastly, just to be clear, the last year or two, you have continued to see an improvement in morbidity?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes.

Thomas Gallagher - *Credit Suisse - Analyst*

Okay. Thanks very much.

Operator

Ed Shields with Sandler O'Neill.

Ed Shields - *Sandler O'Neill & Partners - Analyst*

Good morning, everybody. And thanks for the additional disclosure here. Several of my questions have been answered already but I've got a couple here. First, what is the rate that we can assume for the hedges to amortize into the income statement going forward? It is certainly not going to be linear but any expectations that you can help us have here for the impact on the income statement would be useful.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Sure. And I'm going to turn it over to Amy Corbin.

Amy Corbin - *Genworth Financial, Inc. - CFO US Life Insurance Division*

Ed, this is Amy. Thanks for your question. With regard to looking at our income statement, if you're thinking of stat, I would expect about a consistent trend of about $50 million per year. If you're thinking GAAP, what we tend to see is about the same amount, but as we are approaching more of our amortizing swaps, we expect that trend to rise, and get over $100 million in the next five years.

Ed Shields - *Sandler O'Neill & Partners - Analyst*

Great. Second question I have, as well, relates to your paid loss experience in the product here. If you can give us any kind of information about the paid loss trends, and what variability appears in it, whether you see some cyclicality to it, like one quarter is worse or higher than another. Any information here would be beneficial, as well.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

We do see during the course of the year a little bit of seasonality in claims incidence. I think that we tend to see it -- maybe it's a phenomenon where people go home and spend time with their folks during the holiday season, and they begin to see some things they maybe hadn't seen earlier in the year. And so in the first, say, half of the year, we do see a little bit of higher paid claims than we maybe see in the back half of the calendar year. We see a little bit of that during the course of the year.

Ed Shields - *Sandler O'Neill & Partners - Analyst*

Any other notable trends in paid loss in general over the past several years?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Nothing notable that comes to mind.

Ed Shields - *Sandler O'Neill & Partners - Analyst*

Great. Thank you.

Operator

Joanne Smith of Scotia Capital.

Joanne Smith - *Scotiabank - Analyst*

Good morning. I have a couple of questions. The first one, I just want to go back to the discussion regarding the morbidity and mortality, on the sensitivities. And I'm not quite sure the question was answered as to whether the change in the mortality assumption is more or less conservative.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Morbidity improvement is a bad guy. So it hurts results. Mortality improvement -- I may have misspoke -- mortality improvement is not a favorable development. Because the longer people live, in the case of long-term care, the more folks there are to then go on claims later on.

Joanne Smith - *Scotiabank - Analyst*

So, am I to understand that the change from 10 years to 5 years of the mortality improvement is suggesting that the mortality improvement gets better faster and so that is worse, correct?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

What we find, again, is that there is a high correlation between morbidity improvement, which is a good guy, a favorable development, and mortality improvement, which is a negative. So those things do go essentially hand in hand. Morbidity improvement, the combination of the two is generally a positive thing. But our best estimate assumptions are based on 10 years of improvement in both morbidity and mortality. Again, those things offset to some extent but net-net are a positive. If we look and see that improvement in those two areas continuing for only 5 years, then that obviously has a sensitivity impact on the margins that we disclosed of about $0.8 billion.

Joanne Smith - *Scotiabank - Analyst*

Okay. All right. Thank you. And then my next question is regarding the discussion that you are having with regulators about how the long-term care business should really be looked at more as a health insurance product, rather than a real life insurance product. And I'm wondering if we get to that point where the regulators are fully accepting of that, if we're going to get to some type of situation where they're going to start mandating annual loss ratios, and similar things that they have done maybe with Medicare supplement policies and things. And I'm wondering if that might not necessarily be a dangerous road to go down.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Joanne, I believe the way that the business should be managed is as a health insurance policy. And I have said that to regulators. And I have run health insurance businesses and life businesses over time, and I just think that they ought to be treating long-term care similarly to how they regulate health insurance. Now, that is an ongoing debate. Different regulators, commissioners, governors, others have different opinions on that. But I am going to be pushing very hard going forward that we change the way that the business is regulated because I believe that it is impossible to be in this business long term if you have to set all of your assumptions based on the date the policy is issued. And you can never change or re-rate the policies and you're stuck on the risk without an ability to re-rate, when over 30-year durations interest rates will change, lapses can go up and down, morbidity, mortality, and all of the innovations in medical science. I feel quite strongly that that is needed, we need that regulatory environment.

I'm not saying the regulators in the end will agree. But if they don't, and we're back to where we've been for the last 40 years, in that you can't get smaller, more proactive increases, because I think that is much better for consumers, to get a 2%, 3%, 4% increase more often. And they're used to that on their Medicare premiums, et cetera. That is normal in this space. Why all of us in the industry and regulators didn't view this as a business where you really had to change the assumptions over time, I think made it a very difficult business to manage. I would say I wouldn't be comfortable as the CEO of Genworth going forward in this business if at the end the regulators come out in a place where they won't allow us to get these smaller more proactive rate increases so that we can get things back on track into the price floor loss ratios when we file. And that's exactly how regulators manage health insurance. And so, to me, this is different than health insurance but it is much more similar -- long-term care to health insurance -- than to life insurance.

Joanne Smith - *Scotiabank - Analyst*

My question with respect to how the regulators are going to react to that is health insurance is one thing. It terminates on a private basis at some point in time, whereas this does not necessarily terminate. And if people are getting continual 2% to 4% rate increases, at some point maybe as they get closer to actually needing the policy, they can no longer afford it and they lapse. And I'm wondering how those discussions with the regulators go.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Again, you have to look -- I would compare long-term care to Medicare health insurance. And I do think -- in Medicare the premiums do go up every year, and one way or another, consumers have to pay those premiums. Going forward, there may be subsidies, et cetera. We are working with state and federal governments. I do think we may need to look at that issue, obviously, going -- what we have been doing on our new products, we have been trying to keep the ultimate price point, the actual annual premium, similar to what it has been. Because our experience would say overall consumers seem to be comfortable paying premiums in the $2 billion to $3.5 billion range at the average issue year. And so what you are seeing is, on the new products, we are keeping the pricing at the same range by capitating the coverage more. I think you also, when we do these rate increases, we do allow policyholders, they can pay the full premium, they can decide not to pay any increase. And what will happen is they will reduce the benefit. And, in fact, on average -- it varies a lot -- but on average if a policyholder gets a greater than 50% increase from Genworth, they don't want to pay that, they want to pay exactly what they have been paying. In general, the lifetime coverage would be reduced to somewhere in the four- or four-year range. And that is also consistent with how the new products are being done. And, finally, I just want to repeat that if the policyholders decide not to pay any premium, and they don't want the policy anymore, we do give them the nonforfeiture option, so all of the premiums they have paid in up to that point can be used down the road for claims if they should have them.

Joanne Smith - *Scotiabank - Analyst*

Okay. Thanks very much.

Operator

Steven Schwartz of Raymond James & Associates.

Steven Schwartz - *Raymond James & Associates - Analyst*

Good morning, everybody. And, again, thank you for this. I want to go back to the question of mortality and morbidity. And maybe this clears it up. Morbidity is a reference. Improvement in morbidity means that if you thought somebody was going to take advantage of the policy, go into a facility or whatever, at the age of 80, if they go in at the age of 81, that is an improvement in morbidity?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Can you say that last part again, Steven?

Steven Schwartz - *Raymond James & Associates - Analyst*

Yes. Is improvement in morbidity -- does that mean that people use the policy later than you thought they would?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Basically, it is the incident -- the way we look at it, and as we model it out, is that the incidence rate, you have issue ages and then you have policy age after that. And what we're seeing is that we are having this improvement in incidence rates generally across the population of what we have, so that the rate of people claiming has generally been getting lower at this, on average, 1.6% type of rate per year. The other thing that affects overall morbidity is severity, which for us has been basically flat for the last several years. If you think about the couple of things that impact claims it's how frequently that people claim, which is the incidence rates that we've shown on page 13. The other aspect of it is what is the severity of that claim, how long are they in claim, what is the amount of the claim, and so forth. And that for us has been basically flat.

Steven Schwartz - *Raymond James & Associates - Analyst*

Just so I understand this, if you were originally assuming you sold 100 policies and you were originally assuming that 50 people would eventually use the policy, you're saying that less than 50 people are going to actually use the policy.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes. There are fewer claims -- the number of claims has been improving.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay. All right.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

But keep in mind that that is morbidity. Again, you have to look at all of the factors together. So, even though the incidence for policyholders is getting better through better morbidity, because lapse rates have been much lower than expected, there are a lot more policyholders that are still policyholders, and therefore that's why, net-net on the old policies, why we have seen significant losses. Even though morbidity and mortality has had an impact, the net of that is probably an improvement because the net of those two things together is improvement. You've got to look at them together. But they have been more than offset in a much more significant way by the fact that, if you look on that slide 22, we were assuming 5% lapse rates, and they're now, on average, our experience has been less than 1%. So that is a really big driver. And, of course, since we first started in this business in 1974, we have been in a 30-year-plus secular reduction in interest rates. And that has also had an impact. So when it is all said and done, I think morbidity and mortality matter, it is generally probably been a net positive. If you assume, on our sensitivity, 5 years versus 10, it shows that the combination of those two factors, the better morbidity has offset the longer lives. But what really has hurt us on the old is that the lapse rates, we assumed -- and I think they were reasonable at the start but it is the average of lapse rates we get on life or health policies. But I think because of all of the factors together, these have become such valuable policies, they offer lifetime benefits in the past, that people are not lapsing because they see from a cost/benefit perspective, it has been a very good deal, as it has turned out for them.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay, let me try this one more time then. You start with 100 people. At the end of the day you have 50 people. And 25 of those use the policy. Maybe that's what you started your assumptions. And today you are finding that you start with 100 people, you've got 80 people at the end of the day, 40% use that. So you have actually got 32 people relative to 25 who are using the policy.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, I think that is a representative example. Obviously the numbers would be different. And, again, it is those two factors which offset the improved morbidity incidence rates which have a decreasing impact on the number of claims. But then the difference in lapse assumptions, which increases the amount of claims. And as Tom pointed out, the combination of the two has resulted in a net increase in claims because that was the bigger impact on our pricing assumptions, is the difference in actual lapse rates.

Steven Schwartz - *Raymond James & Associates - Analyst*

Right. And improvement in mortality is not only going to lead to more people holding on to the policy at the end of the day, since they haven't passed away but they are presumably going to live longer on claim.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Correct, yes. Lower lapse rates and lower mortality rates basically mean people are around longer to claim and so that would increase the number of claims. And lower morbidity incidence rates decrease the number of claims. So there are three different dynamics going on.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay. You know what? -- I'm going to leave it there. Thanks.

Operator

Jimmy Bhullar of JPMorgan.

Jimmy Bhullar - *JPMorgan Chase & Co. - Analyst*

Hi, good morning. You present a good case for why newer policies are better underwritten or better priced. But at the same time you're applying for price hikes on business that you've sold even in the last couple of years. So maybe if you could discuss the rough magnitude of price hikes on 2011, 2012 business. And also discuss what the assumptions are, or what the key drivers are that have varied from your pricing assumptions on those vintage years.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

If you look at slide 22, Jimmy, those policies that we are applying for -- and it's 6% to 13% are the Choice 2 blocks. So, those are Choice 2, 2.1. And, as you can see, basically the lapse rates that we assumed originally were 1.5%. And, again, we're finding on average 0.7% is the ultimate. So, part of the increases correct for that. Obviously, because we're catching it earlier and more proactively the amount of increase to correct is smaller. And the same, at 5%, interest rates, obviously if you look at new money today, is probably, new dollars are being invested. Again, on average, our rule of thumb is the treasury plus 20 basis points. Actually doing a little bit better than that. So, again, there's some impact from that.

So what we're doing in the Choice 2, 2.1, which is unlike the old block, where the old block we're just trying to get it to break-even, on Choice 2 and 2.1 we're trying to get back to the original pricing assumptions and the original price floor loss ratios. And on the PC Flex, Flex 2.0 and 3.0, you can see we're much closer to what we actually think in terms of where interest rates are today and the lapse rates of 0.7%. But things could evolve differently or, as some of the earlier questions, the combination of morbidity and mortality may mean, and low lapses, more people living longer, making plans, et cetera. And, again, as we see that, I think the only way to manage this business is you have to apply for small increases to get you back on target with the price floor margins and loss ratios. And, again, that is my main point to the regulators -- is, I think that's a better way to manage the business because it will result in much smaller price increases. We may find on PC Flex 2.0 and 3.0 that the assumptions hold for the next 30 years and we never have to do a price increase. So I do think that those are probably starting out being more conservatively priced. They're clearly more conservatively underwritten since we're doing a lot more cognitive testing and the labs and all of the blood work. So that is the point we're trying to make.

So, on Choice 2 and 2.1, it is 6% to 13%. We are asking the regulators to look at projected loss ratios versus actual, because right now in those blocks the loss ratios are in the single digits. But we know based on these assumptions, and where we are, and based on our overall assumptions that Marty covered, that we need some increase. We filed these in September, and we have already received three approvals from states. So clearly, it does appear that the state regulators -- I'm not saying that all of the states will get onboard with this right away, but I do think that we are making progress in that front.

Jimmy Bhullar - *JPMorgan Chase & Co. - Analyst*

And your success rate in convincing the regulators on the last couple of years of raising prices, is that similar to your overall success in raising prices, more or less?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Yes, I think overall, I think we have had reasonable success. And I do want to commend the regulators. They have a lot of things to balance, including a lot of consumer advocacy and what consumers -- and particularly they're sensitive on these consumers because, in general, they're older ages and they look at affordability and all of that. So I think they're balancing that. They also have a responsibility to the companies to allow for reasonable rate increases as things evolve and assumptions that we price for turn out to be much different. So I think, collectively, and it is going to be a moving process. And I take a very accommodative approach with regulators. I think it is very important from a public policy perspective that we have a private market for long-term care. I think certainly the governors and the heads of Medicaid in all of states, they are already paying 25% to 50% of the Medicaid budget today, that it was supposed to go to the poor, for long-term care payments. They never expected that. And they know they're facing 76 million baby boomers who, let's say, one-third of which, maybe more, are going to ultimately make long-term care claims. And so I think they also want to create a regulatory environment framework, obviously, that protects the consumers and existing policyholders in the future. But they also need to make the business manageable for the insurance carriers, so there is enough carriers that stay in the business, so that there is a reasonably robust competitive market for long-term care. So I do think at the end of the day -- I've met with many of them, insurance commissioners and governors -- I think that they do want to work with us. They will be obviously more concerned about the impact on consumers. And I think they should, that is part of their job. But I do think in the end we are going to come out in a place that allows for a robust competitive market for long-term care.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

One thing, Jimmy, as a side bar, is in the recent rate actions of 6% to 13%, on Choice products, they are not included in the margins here. That's not to say we don't expect to get premium from those. We actually do. But we did not reflect any of those premium increases in the margins that we presented this morning.

Jimmy Bhullar - *JPMorgan Chase & Co. - Analyst*

Okay, thank you.

Operator

Craig Perry from Panning Capital.

Craig Panning - *Panning Capital - Analyst*

Hi, guys. Thanks so much for providing all of the detail today. I just had a quick question, it's a follow-up on slide 22. And, really, it is more of a summation so I can just contextualize and understand where we -- I think this call did a great job of outlining, as it was supposed to, your reserving policy and helping us think through essentially the legacy book. But you did not spend much time talking about the new book, and in particular PC Flex 3.0, which you just filed to start selling. The comment that you thought you would make 20% ROEs is new and obviously very interesting to some of us. Can you help us think through slide 22? If we're staring at this slide in two years, what is the blended -- it looks like there is $600 million of old in-force block, which, with the combination of legacy rate increases, you're hoping to get to break even, and the new block is $1.5 billion. And we're trying to get PC Flex 3.0, you said $200 million or so. Can you help us think through in two years how we're supposed to think through the blended ROE of that, of this business, given the developments that you expect and given the trends? You have some actual experience to think it through. Can you help us think through what the blended ROE would look like in two years on all of this, on long-term care, within a range?

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

Craig, at a very high level, I would say you've got to look at the old block as the goal if we get the price increases we're assuming, we get those closer to break even. So, no return or a modest negative return. I think on the PC Flex, Flex 2.0 and 3.0, we would expect the returns on those to be 15% or better. I think Flex 3.0 at this point, we would say 20% or better. And then on the Choice 1, Choice 2, Choice 2.1, I think they will be double digits. Where they end up is a little bit unclear because that is where we have to go to this new regulatory process.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

And I would also just add that over the next couple of years we'll, with Select 3.0, see how it does in the market. But we would expect to sell between $150 million, $175 maybe, maybe $200 million over the next couple of years per year.

Craig Panning - *Panning Capital - Analyst*

So per year. So, your total in-force premium in two years could be about $300 million-ish, depending on uptake and all the other things?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Incrementally, yes, something like that. And then obviously if you look at the really old block, you look at pre-PCS, you have a --.

Craig Panning - *Panning Capital - Analyst*

And where do we think -- I'm sorry, I apologize, just based on the K, before you answer that question, the old block of $600 million that you are hoping to get to break even, in two years, based on lapse rates and actual mortality experience, does the $600 million go to $500 million? Or how does it decay based on the existing age profile of the people that are there?

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

If you think about the old block, and you can look at and see the average detained age, at some point the force of mortality as the actuaries call it, really begins to take effect in a very big way. So, I think you will begin to see the pre-PCS block begin to decline in the lives in force. Obviously the premium will change because of the rate actions, it will go up a bit, but the lives in force will begin to diminish over time, so you will begin to see that. I don't know that in a year or two it's going to be too significant. But over the next 5 to 10 years you will begin to see some of those older blocks begin to roll off the books, if you will.

Craig Panning - *Panning Capital - Analyst*

Yes, that is very helpful. So, in the words of Forrest Gump -- I'm not a particularly smart man but if I think through this, in two years you would certainly be on target to be in your double-digit ROE business for the long-term care business.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, I would point out that on the older block, and some of these other rate actions, that they do take time to take effect. So we are --.

Craig Panning - *Panning Capital - Analyst*

Right, it doesn't all come into the P&L statement.

Marty Klein - *Genworth Financial, Inc. - EVP & CFO*

Yes, we're still implementing the rate actions on the old block, if you will. And those are beginning to take effect in our earnings. It is really going to be another two, three years, and really over probably a three- to five-year time frame that those really begin to take hold. And then, similarly, we've just begun filing these last few months on the Choice 2 products. And, again, that takes two, three, four years to begin to take effect. So two years out, you will begin to see some improvement, for sure, but it is not as if those rate actions would be fully in effect it at that point in time.

Craig Panning - *Panning Capital - Analyst*

Sure, but from the perspective of somebody who is doing discounted cash flow, that doesn't really matter. If I know I am getting it a year or two years from now, if it shows up or doesn't show up, it doesn't really matter, we know it is there. Yes, I appreciate that. Okay. Thanks, guys. Again, thank you very much for the call. And thank you for taking the questions. Very helpful.

Operator

Thank you. Ladies and gentlemen, I will now turn the call back over to Mr. McInerney for closing comments.

Tom McInerney - *Genworth Financial, Inc. - President, CEO & Acting President & CEO US Life Insurance*

I want to thank all of you for joining us today and all of your questions. Obviously, this is a complex business. We have 40 years of in-force policies, so it is challenging to understand. But I do want you to know that Marty and I have spent enormous amounts of our time, with weekly meetings with the team. So I think we have really dug into all of this and all of these numbers. And I think we feel very comfortable that we understand how it all works and how all of the risks work. And we hope that you found the information that we provided around our long-term care balance sheet and the assumptions helpful. We will consider over time what input you give us in terms of how we can make further improvements to the disclosures and transparency. Obviously there is significantly more disclosure than we or the industry has done so I hope you all do appreciate that. As I said, Marty and I, and I think the whole team here, having spent four months and a lot of time and effort, we're now becoming increasingly confident that we can proactively manage the business. And, obviously, we need to work well, and we're very willing to work with state governments on this, and potentially the federal government. We do think that we have learned a lot. And so in our new PC Flex 3.0 policy that we just filed on November 26, we filed it through the compact, there are 38 states in the compact, so hopefully we will get approvals in a reasonable amount of time there. And then we will also file in the other states. We do expect returns in excess of 20% on that. And, so, given all that we are doing to improve the existing business and the new business, we really do believe that the long-term care business for Genworth represents significant opportunity for us going forward.

Operator

Thank you. Ladies and gentlemen, this concludes Genworth Financial's long-term care insurance investor conference call. Thank you for your participation. At this time, the call will end.