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Advantages, Disadvantages and Considerations for LTC Policy Buyouts

By Jeff Anderson and Mike Bergerson

Recently, there has been a lot of buzz around the possibility of offering a buyout option for long-term care (LTC) policies alongside a rate increase request. This option was utilized in 2017 as part of rate filings for Penn Treaty Network America Insurance Co. These filings offered a cash payment equal to the greater of the actuarial liability of a reduced paid-up policy and 50 percent of the actuarial liability under the policy, with consideration for the respective guaranty association limit.

While we have seen other innovative rate increase ideas, such as landing spots, spread like wildfire to other LTC carriers, we have not yet observed a proliferation of the LTC buyout option. There may be multiple reasons for this, but we believe the most fundamental is the difference between a going-concern insurance entity and an entity being managed by guaranty associations. That being said, other carriers are considering buyout options as a way to manage their LTC book of business. A recent rate increase filing for another company included what could be viewed as a buyout option by allowing certain policyholders that dropped their coverage as part of the rate increase to receive a full return of premium paid less any benefits received.

The remainder of this article will explore the advantages and disadvantages of LTC policy buyouts from various stakeholder perspectives and discuss actuarial considerations for a carrier thinking about offering a buyout option.

There are several advantages and disadvantages to LTC buyouts, which vary by stakeholder and are described below. Depending on the structure and acceptance rate of the buyout, along with the level of adverse selection, a buyout could be either advantageous or disadvantageous from a financial perspective for multiple stakeholders. If the buyout is well structured and does not have unfavorable selection, it could increase financial stability for the company and premium stability for remaining policyholders. Alternatively, if the structure is unsound or if there is



severe adverse selection, a buyout could result in worse financial performance than would otherwise have been expected.

CARRIER PERSPECTIVE

We will continue our summary of the advantages and disadvantages of LTC buyouts from the perspective of the insurance company.

Advantages

- The liability is quantified and settled for policyholders that accept the buyout offer. This is important because the company's future contractual liabilities and downside risks for these policyholders are effectively released.
- Removing policyholders from the block will reduce uncertainty for management.
- Uncertainty and riskiness will decrease for rating analysts and other external stakeholders, providing an opportunity to view the block more favorably.
- The company will not have to file additional rate increases for policyholders that accept a buyout. Rate increases on LTC business have become a fact of life in many cases and carriers are seeking ways to limit or eliminate continued rate increases.
- Certain expenses based on volume, such as per policy administration fees, will be reduced as there will be fewer policies after the buyout.

Disadvantages

- A policy buyout offered to policyholders could result in legal challenges, such as class action lawsuits by policyholders that accept the buyout but then need LTC services in the future. Even if the company is successful in defending the buyout, litigation can be very expensive.

- It is certain that not every policyholder would accept a buyout offer; rather it would be accepted by only a fraction of the population. The company should expect that the population not accepting a buyout offer would exhibit higher levels of morbidity due to adverse selection. We discuss this important consideration in detail later in this article.
- Regulators may not be amenable to approving buyout offers. At the 2019 Intercompany Long Term Care Insurance (ILTCI) Conference in Chicago, a small number of regulators indicated they were hesitant to allow buyout offers for going-concern companies.
- A buyout offer may go against a company's mission and vision of protecting insureds in their time of need. This may be an especially important consideration for mutual insurance companies and fraternal benefit societies.
- Expenses on a per policy basis may be higher after the buyout because fixed costs will be allocated to a smaller base of policies. Additionally, a payment to agents may be necessary to offset the loss of future commissions on policies that accept a buyout.

REGULATOR PERSPECTIVE

The next perspective we will consider for policy buyouts is that of the insurance regulator.

Advantages

- Policyholders have more options available to them. Rate increases are difficult not only on policyholders, but also on regulators and company personnel. If policyholders are able to make informed decisions, having an additional option available to them when faced with a rate increase may be a positive.
- For policyholders that accept a buyout offer, there will be no additional premium and, therefore, no additional rate increase requests.

Disadvantages

- LTC is already a strain on state Medicaid budgets. Private LTC insurance has low penetration rates and states are looking at ways to expand coverage options. Buyout offers would instead reduce coverage by eliminating existing policies. This could lead to even more strain on the Medicaid system.
- Regulators may have concerns about whether policyholders can properly assess the value proposition of their buyout offer compared to the existing coverage and make an informed decision.
- Adverse selection, as mentioned above, could lead to the remaining pool of policyholders having higher than average morbidity. If severe, this could lead the block to have worse financial performance than prior to the buyout offer.

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POLICYHOLDER PERSPECTIVE

Finally, it is important to also consider the perspectives of policyholders regarding a buyout offer.

Advantages

- They have an option to “get out” of the contract and get some portion of their premiums back. Anecdotally, we have heard that some policyholders have tired of consistent rate increases and inquired about being able to cancel the policy and get their money back. A policy buyout would give these policyholders the type of option they are looking for.
- Policyholders that have been subject to rate increases can make a final decision, similar to electing a paid-up shortened benefit period option, so that they will not be subject to future rate increases and need to reevaluate their LTC needs in response to a future rate increase.

Disadvantages

- Policyholders that accept a buyout will no longer have coverage and may not be able to purchase a new policy. While policyholders will have aged since the policy was issued and may have a better idea of their health status than they did at policy issue, they will still most likely not be able to accurately determine if they will ultimately need LTC services.
- Adverse selection of those declining a buyout offer could lead to more uncertainty regarding future benefits for the remaining policyholders. In an extreme situation, a poorly designed buyout or severe adverse selection could result in company insolvency. If management is transferred to the guaranty associations, benefits may be reduced.

KEY ACTUARIAL CONSIDERATIONS

If a company has weighed the various advantages and disadvantages of offering a buyout and decided to move forward, there are still many additional considerations prior to implementing the decision. Three such actuarial considerations described below are (1) how the buyout amount should be calculated, (2) the potential impacts of adverse selection and (3) interaction with reinsurance.

Valuing the Buyout

There are multiple ways that a company could value a buyout offer. These range from relatively simple options such as 100 percent of premiums paid, to complex options such as a project-



ed future net liability with premium capping and claim offsets. The overall goals of the company should be considered as they will impact the structure of the offer. Potential objectives include reduced LTC liabilities, ease of administration, perceived fairness of the offer by consumers and regulators, the perception of the offer by rating agencies and analysts, and the impact on other stakeholders. Once the objectives are understood, there are multiple options that could be considered in calculating the buyout. These can be classified as premium-based, reserve-based or a composite. All options should consider an offset for historical claims paid.

The simplest premium-based option is full return of premium. This has the benefit of being easy to administer and explain but could be a very generous benefit relative to expected future liabilities depending on the characteristics and age of the block (e.g., a late duration block with high attained ages may have higher historical premiums than expected future liabilities). Companies could also consider offering a reduced percentage, such as 75 percent of the historical premium, with the reduction, along with lost investment income by the policyholder, justified as the cost of insurance since issuance of the policy.

The simplest reserve-based option is a buyout based on statutory reserves. The active life reserve, unearned premium reserve, disabled life reserve (DLR) and allocated-incurred-but-not-reported reserve could all be considered, although there are reasons to exclude the DLR. The DLR held for active claimants is often quite large, but it is less than the full policy benefit. Therefore, we expect that buyout acceptance for active claimants will be quite low. Additionally, a buyout offer for active claimants could be received unfavorably by regulators and raise legal concerns.

An alternative reserve-based approach is to base the buyout on an estimate of the present value of future liabilities. Projected cash flows from premium deficiency reserve (PDR) testing or cash flow testing are already used to estimate reserve sufficiency. Best estimate projections at a policy level could be discounted to estimate the present value of future claims and expenses in excess of future premiums. The resulting net liability could then be used as a basis for the buyout. However, there are both practical and theoretical concerns with this approach.

From a practical perspective, it may be onerous to develop and store projection results at a policy level. Many projection systems are not capable of producing policy-level results without adjustments to the setup. Additionally, the company should consider the amount of expenses that it actually expects to save (e.g., certain costs are fixed) and whether a payment to agents for lost future commission will be necessary. From a theoretical perspective, the key consideration is the applicability of projections at a policy level. For a block in aggregate, projections generally represent a reasonable proxy for future cash flows. This is not the case at the policy level where policyholders do not behave like the average. Some will have very high levels of claims and others will have no claims at all.

There are various ways to combine the options noted above into a composite buyout offer that includes both premium and reserve components. As noted previously, we would expect most buyout offers to have a cap and/or a floor that is based on percentages of the historical premiums paid, along with an offset for historical claims paid. Key considerations in any composite calculation are the ease of administration and communication with stakeholders.

Adverse Selection

Insureds likely have a better understanding of their short- and mid-term needs for LTC coverage than the company. This information asymmetry leads to adverse selection. If policyholders believe they will not utilize their LTC benefits, they will be more inclined to accept a buyout offer.

The two extremes of selection are perfect selection (i.e., the insured has perfect knowledge of all future LTC needs) and no selection (i.e., the insured has no knowledge regarding their future LTC needs). In a perfect selection scenario, insureds who know they will have very little or no claims will accept the buyout. This would reduce future premiums but result in an immaterial reduction to future claims. In this scenario, the buyout would have a materially negative impact on the company. In a no selection scenario, we would expect reductions of similar proportions to both future premiums and future claims.

Using sample insured data, we modeled the potential impacts of a buyout for various acceptance rates and adverse selection scenarios for two example buyout structures. We randomly selected sample acceptance populations for each acceptance rate from the

non-claimant premium-paying population and removed their experience from our projection model. We sampled 10 acceptance populations for each acceptance rate in a Monte Carlo-style simulation and analyzed the changes to cash flows. Table 1 provides metrics for the insured population used in our analysis.

Table 1
Overall Population Metrics

Metric	Value
In-force policy count	16.3k
In-force annualized premium	\$31.1M
Average attained age	64.2
Total historical collected premium	\$431.7M
Total historical paid claims	\$48.6M
Statutory reserve (excl. PDR)	\$409.7M
Best estimate gross premium reserve	\$510.2M

As can be seen in Table 1, the block used in our analysis is in a premium deficiency situation, even prior to the inclusion of any margins for adverse deviation in the projection assumptions. For a block with sufficient premiums, consideration should be given to the estimated release in statutory reserves as part of a buyout. Our analysis focused on the change in the gross premium reserve.

In the perfect selection scenario, we assumed that only policyholders who know they will have no future claims accept the buyout. This was modeled by assuming no reduction to future claims but a reduction to future premium based on each sample acceptance population. In the no selection scenario, we removed both the projected premiums and claims for each sample acceptance population.

We also considered a middle ground selection scenario in which only a portion of future claims for the sample acceptance population is removed. In this scenario, we assumed that 10 percent of projected claims for the sample acceptance population would be removed in years 1 through 3, 50 percent in years 4 through 6, and 90 percent in years 7 and later. This scenario is based on judgment, assuming that insureds have a better understanding of their short-term LTC needs (close to perfect selection), but over the long term they have imperfect knowledge and the claim reductions will revert to a level close to the no selection scenario.

Tables 2 and 3 illustrate the potential impacts of adverse selection at multiple acceptance rates in the three noted selection scenarios assuming two different buyout offers: 75 percent of historical premiums paid and 75 percent of the best estimate present value of future net liabilities. The best estimate future net liabilities are calculated as the sum of future claims and expenses, less future premiums, discounted to the valuation date at 5 percent. The gain/(loss) is calculated as the decrease in the best

estimate future net liability, less the cost of the buyout payments. The tables present the average results for the 10 simulations within each acceptance rate. The varying acceptance rates illustrate the sensitivity of the results to the portion of policyholders assumed to accept the buyout.

Table 2
75% of Historical Premiums Buyout (in \$Millions)

Acceptance Rate	Gain/(Loss) by Selection Scenario*		
	None	Middle Ground	Perfect
1.0%	1.1	0.2	(5.0)
2.5%	3.3	1.2	(12.9)
5.0%	6.2	1.9	(25.5)
10%	12.3	3.7	(50.9)
20%	24.5	7.5	(101.1)
30%	37.4	11.8	(151.8)
50%	62.1	19.7	(251.8)

* Gain/(Loss) = [decrease in best estimate future net liability] – [cost of buyout]

Table 3
75% of Best Estimate Future Net Liabilities Buyout (in Millions)

Acceptance Rate	Gain/(Loss) by Selection Scenario*		
	None	Middle Ground	Perfect
1.0%	0.7	(0.1)	(5.3)
2.5%	2.0	(0.1)	(14.2)
5.0%	4.0	(0.3)	(27.7)
10%	7.9	(0.7)	(55.3)
20%	16.1	(1.0)	(111.9)
30%	23.7	(1.9)	(165.5)
50%	39.3	(3.1)	(274.6)

* Gain/(Loss) = [decrease in best estimate future net liability] – [cost of buyout]

As shown in Tables 2 and 3, the perfect selection scenario is very unfavorable, while the no selection scenario would result in gains (i.e., decreases in net liabilities net of the buyout cost). Neither of these results are particularly surprising as we believe these are the most likely outer bound scenarios and actual results should lie somewhere within their range. The middle-ground selection scenario results in gains if the buyout is valued as 75 percent of historical premiums but results in losses if valued as 75 percent of the best estimate future net liabilities. For an older block, with more historical premium, there may be losses under either option as structured for this analysis. Additionally, note that the values in the tables above are the average results. When looking at the minimum and maximum middle ground

scenario results within the simulations, there are simulations of the premium-based buyout with losses and simulations of the net liability-based buyout with gains. This variability is based on the mix of business assumed to accept the buyout and presents an additional unknown for companies to consider when valuing a buyout.

Reinsurance

In addition to the items discussed previously, the interaction of the buyout with reinsurance should also be considered. There is a range of reinsurance types within the LTC industry and many blocks have reinsurance coverage. Depending on the structure, a buyout offer could have varying impacts, so a company considering a buyout should discuss the calculation and cost sharing of the buyout with their reinsurers. In addition to determining how the cost of any buyouts accepted would be shared, reinsurers would likely also be interested in the impact of adverse selection for persisting insureds.

While the calculations for a coinsurance treaty are relatively simple, complications arise for treaties with excess of loss (XOL) coverage and/or treaties with a yearly renewable term (YRT) premium schedule. For treaties with XOL coverage, the calculations should consider how much of the savings from any buyout are related to risks above the attachment point. Additionally, the leveraging effect of the attachment point in XOL treaties may amplify the impact of adverse selection. For both XOL and YRT treaties, another consideration is whether the reinsurance pre-

miums would remain adequate after a buyout due to an increase in aggregate morbidity attributable to adverse selection.

CONCLUSION

There is not yet a consensus on whether buyout offers will see widespread adoption within the LTC industry. As discussed, there are several stakeholders impacted, with advantages and disadvantages for each. The various complications and considerations may result in limited industry recognition of buyout offers as a viable approach to manage LTC risk. However, it is also possible that the industry is waiting for a structure to emerge that balances the impacts on the various stakeholders and is well received by both regulators and consumers. If that were to happen, we may see a wave of buyout offers, which could result in a dramatic shift in the risk profile of the LTC industry. ■



Jeff Anderson, FSA, MAAA, is an actuary at Milliman. He can be reached at jeff.anderson@milliman.com.



Mike Bergerson, FSA, MAAA, is a principal and consulting actuary at Milliman. He can be reached at mike.bergerson@milliman.com.

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