Article from:

Long-Term Care News

April 2004 – Number 11

SOCIETY OF ACTUARIES

April 2004, Issue No. 11

Long-Term Care News

The Newsletter of the Long-Term Care Insurance Section — Published by the Society of Actuaries

Smaller Insurance Companies and Long-Term Care Insurance

by Tony Proulx

Since the introduction of long-term care insurance in the 1980s, the marketplace has been dominated by a few large insurance companies. Sixty percent of the industry sales in 2002 came from the top six companies[1]. There are several reasons for this situation:

- Long-term care insurance was an experimental coverage. The morbidity risk was not well understood. Although there may have been some comfort with the nursing home risk, the home care risk was unknown. If carriers wanted to enter the marketplace, they needed to be prepared to learn from their mistakes. In addition to the morbidity risk, these long duration contracts also carry a significant reinvestment risk.

- A company entering the long-term care insurance marketplace needed to make a significant investment in developing home office expertise and agent training. The product development, actuarial, compliance, underwriting, claim adjudication and sales and marketing functions are more complex than for any other line of business. For example, a very competent life claim examiner would be ill at ease when adjudicating claims based on a loss of activities of daily living definition. (The activities of daily living commonly used in long-term care contracts are bathing, continence, dressing, eating, toileting and transferring.) The critical mass needed to justify the investment in developing such expertise was estimated to be between $25 million to $50 million of inforce annual premium.

- Long-term care is a capital intensive product. There is a large first year loss. The risk-based capital formulas are onerous. There is some relief when the volume of inforce long-term care insurance premium reaches the $50 million mark and the premium factor in the C-2 formula reduces from 38.5 percent to 23.1 percent. But the smaller companies have no chance of reaching this level.

Some of these hurdles still exist today. However, the smaller insurance company now has a wide variety of help available.

- The long-term care insurance risk is better understood today. The recurring intercompany study of the SOA Long-Term Care Experience Committee provides a solid basis for many of the pricing assumptions. Actuaries also use the Non-Insured Community-Based Long-Term Care Incidence and Continuance Tables from the SOA. These tables are based on the National Long-Term Care Surveys

continued on page 4

contents

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sponsored by the National Institute on Aging. In addition to these sources for assumptions, some painful lessons have been learned regarding liberal benefit triggers, loose underwriting, cognitive impairment risks, voluntary lapse assumptions, etc.

- Reinsurance is available. This can help by transferring a portion of the morbidity risk and the reinvestment risk. Reinsurance can also provide some relief of the capital burden and surplus strain. Financial reinsurance is available from offshore companies. Risk reinsurance can be in the form of a quota share arrangement, or it can be a stop-loss form, aggregate or specific. The specific stop-loss limit may be a dollar limit per claim or a claim duration limit.

- There is expertise for hire. Consultants can aid in the product design, pricing, product filing, administrative systems, financial reporting systems and experience monitoring systems. The consultants are there to get the product up and running.

- There are numerous vendors who can aid in the home office functions of continuing compliance, underwriting and claim adjudication. They can provide sales and marketing support, including illustrations and needs analysis systems. These vendors are generally very flexible in providing as much or as little hand-holding as desired. For example, the insurance company could agree to let the vendor initially underwrite all the applications. In the meantime, the vendor would train the company's staff. Eventually the bulk of the underwriting would be transferred to company personnel. The arrangement may call for the vendor to continue to assist on the difficult decisions. In this way, the smaller company staff still has the vendor's expertise available. The smaller insurance company does not immediately need their own in-house experts. For some functions they may choose to always use hired expertise. They do not need to reach that critical mass.

- The Health Insurance Portability and Accountability Act of 1996 (HIPAA) granted tax-favored status to policies meeting the specified requirements. This has brought much greater uniformity to contracts. In 2002, 92 percent of all policies sold were tax-qualified[2]. This standardization makes it easier for consumers to compare policies, but also leaves them with fewer choices in benefit design. In some sense, HIPAA created a more level playing field for the smaller insurance companies.

I believe all these developments eliminate or lower the hurdles of entry into the long-term care insurance marketplace. Notice that I said some are lowered, not eliminated. This is still a complex, ever-evolving product. However, the long-term care insurance business offers some attractive rewards for smaller insurance companies.

The appeal of the long-term care marketplace has always been in its potential. There is a clear need for long-term care insurance. The average cost for a one year stay in a nursing home exceeds $57,000[3]. This is a financial risk that few individuals can shoulder. The market is under-penetrated. There are only 5.5 million policies inforce[4]. There are 77 million people in the baby boomer generation. The oldest of these reach age 65 in 2010. All these facts contribute to a tremendous untapped market.

Offering long-term care insurance will benefit your distribution force. Long-term care insurance is a high premium product. The average annual premium is nearing $2,000. The large premium generates large commissions. It can provide significant supplemental income for the agent. An additional product offers an opportunity for cross selling and can open the door for a complete review of a client's insurance needs.

The long-term care insurance product generates very large active life reserves, especially when inflation protection is included. The high active life reserves provide an opportunity for the insurance company to earn additional profit on their investment spread. The flip side, of course, is the reinvestment risk.

I have some advice for those smaller companies seriously considering entering the long-term care insurance marketplace. First and foremost is to keep your offering simple. Avoid the bells and whistles. In my opinion, long-term care insurance is meant to cover catastrophic expenses. The insured does not need a prescription drug benefit, a wellness benefit or a medical response system benefit. These ancillary benefits add little value, may only confuse your agents and will keep your claim examiners busier than you would like.

Also under the heading of simplicity, I suggest that you keep the number of plan options limited. Very few applicants choose a 180- or 365-day elimination period, so don't even offer them. Avoid zero-day elimination periods. They have had poor experience. A longer elimination period will weed out trivial claims and help control the claim volume. Be sure there is a large enough spread among the available benefit periods. For example, offer a choice of two-, five- and 10-year plans. This gives the insured the choice of minimal, medium or maximum coverage. Don't offer plans that are too close together. You want to keep the choices meaningful. You don't want to be explaining why a six-year benefit period costs only 5 percent more than a five-year benefit period.

Another important consideration is the contract type. There are three types. The reimbursement model pays benefits based on actual expenses incurred. The indemnity model pays the full benefit, regardless of the dollar amount of expense incurred. The disability model goes one step further in that it pays the full benefit without requiring that any health care services be provided. Of course, all three types require that the claimant meet the benefit trigger, such as loss of activities of daily living or severe cognitive impairment. I recommend the indemnity model for smaller companies. Some actuaries argue that the reimbursement model is better because it avoids overinsurance. But I believe that if the disability is severe enough to cause the loss of activities of daily living, then the insured will have enough nonmedical expenses that overinsurance is not a concern. Also, the indemnity model eases the adjudication process. The examiner does need to review every bill to determine the benefit amount. I recommend against the disability model for smaller companies. I do have concerns with overinsurance with this model. Also, it places greater emphasis on the examiner's determination of satisfaction of the benefit trigger.

Underwriting is everything! The expected claim incidence is very low. A few extra claims from weak underwriting can be disastrous. Use the expert services that are available, at least until your own underwriters are sufficiently trained.

Finally, price your products conservatively. Typically smaller companies will have little competition for long-term care insurance. Smaller insurance companies tend to have market niches where their competitors usually do not even offer long-term care insurance. They may have a captive agency force. The current environment is conducive to conservative pricing. Many large companies have implemented rate increases recently. The product is priced to be level premium, so these increases have not set well with the regulators or agents. They present a significant burden to a senior person on a fixed income. In response to this situation, the current NAIC LTCI Model Regulation has removed the minimum loss ratio requirement. Instead the model regulation emphasizes rate sufficiency, placing increased responsibility on the pricing actuary to encompass "moderately adverse" experience deviations into the initial pricing. Regulators have felt that policyholders are better served paying a higher initial premium with a smaller chance for future rate increases. At last count, 17 states have either adopted the new model regulation or their own form of rate stabilization.

In summary, I believe that there is a place in the long-term care insurance market for the smaller insurance company. The carrier needs to utilize the services of outside experts. Their product should be simple in order to be more easily understood and more easily administered. Now is a great time to take the plunge! Recent emphasis has been on rate sufficiency and not rate competition. Market penetration is low and with the graying of the baby boomers the potential is tremendous. A well-designed, appropriately priced long-term care insurance product can be profitable for you and provide financial security to your policyholders.

[1]Fifth Annual Long Term Care Insurance Survey, James M. Glickman, Broker World, July 2003

[2]Ibid

[3]Survey conducted by Evans Research Associates, sponsored by GE Financial's Long-Term Care Division

[4]LTCConsultants.com ❋

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