SOCIETY OF ACTUARIES

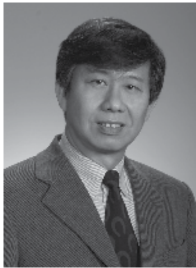
Article from:

Long-Term Care News

May 2012 – Issue 31

Deconstructing Long-Term Care Insurance

by Robert Yee



Robert Yee, FSA, MAAA, was the chief actuary for the Office of CLASS and is currently a principal and consulting actuary at Davinci Consulting Group LLC. He can be reached at *bob.yee@davinciactuaries.com.*

In spite of the growing need for long-term care financing, two observations about the current state of long-term care insurance market are inescapable. Recent sales are stagnant relative to the perceived demand. The number of insurance companies offering long-term care insurance is dwindling in both the individual and the group markets. These are clues that the current product offering is perhaps not working well for the consumers and the insurance companies. This article examines some of the shortcomings of today's product and suggests a different approach.

WHO WOULD WANT TO BUY THIS?

The vast majority of policies sold today have level premiums payable for life. However, history would suggest that premiums are likely to increase later when sufficient experience emerges. Many insurance companies with long-term care insurance business have implemented rate increases in at least one segment of their business.

Long-term care insurance premiums are determined from projections of future claims, voluntary lapses, mortality, investment returns and expenses. Because the business is highly persistent, small changes in the persistency and investment assumptions will have a large impact on the magnitude of the premiums that are necessary to fund future claims. Because the frequencies of claims are relatively low, credible claims experience develops slowly. Even though state insurance regulators cannot deny justifiable premium rate increases, they are reluctant to grant the amount of the increase as requested. Multiple rate filings are becoming a common practice. These factors all contribute to the uncertainty of both the timing and the size of the increases.

Almost all policies provide no cash value if the insured lapse or die.[1] While this feature helps to keep premiums low, it presents a problem for the insured when they are faced with a premium increase. Switching to another insurance company can be very costly because level premiums go up by the age at purchase. The insured will have to pay the higher new premium without receiving a residual value from the old policy. The older the policy, the more expensive it will be to replace.

On the benefit side, many insured may not claim for 20 or more years. Even though today's comprehensive policy covers a variety of care, the vast majority are still restrictive in that services will only be paid if they are specifically listed on the policy. However, long-term care services and supports are continuously evolving. Nursing home only policies purchased years ago have a declining utility today as home and community care are increasingly in vogue. The distinction between sub-acute and long-term care is blurring. Telecommunications technology is emerging to manage chronic diseases in the home setting. People's attitudes and preferences for care will likely change. There is a genuine concern that today's policy will not pay for prevailing services in the future. The alternate plan of care provision in most comprehensive policies offers no guarantee for relief since any "outside the box" benefit is at the discretion of the insurance company.

As a group, insurance companies' perseverance for their long-term care insurance business is questionable. Quite a number of them have left and, not surprisingly, rate increases soon followed. Hardly any insurance company that entered the market in recent years offered the traditional level premium policy.[2]

Given the uncertainty surrounding the premiums, the future relevancy of the benefits and the companies' commitment, a prudent buyer would hesitate.

WHO WOULD WANT TO SELL THIS?

Insurance companies are facing challenges on multiple fronts. In the early years, the long-term care insurance industry was plagued with mispricing from aggressive claims assumption and loose underwriting. The fairly large premium increases on older blocks of business failed to restore profits to the pricing expectation because of further

claims deterioration. Many seasoned companies in the industry have this baggage in their long-term care insurance business. Insurance companies have also erred in over-estimating the number of insured lapsing and dying. A small percentage decrease in the actual number of insured lapsing and dying will turn into a relatively large proportion of the insured claiming eventually.

Managing the investment risk is perhaps the greatest challenge for insurance companies. Investment income in long-term care insurance is a significant source of revenues. Moreover, there are very few investment instruments that can adequately provide the cash flow to match the long-term liability cash flow generated by long-term care insurance. During periods of low interest rates such as in recent years, this could be a serious concern for the in-force business. Cash flow generated from assets backing the reserves would be reinvested at rates below the original pricing interest rate assumption. Future profits would suffer.

For new business, companies would need to re-price with a lower interest rate assumption. A rough rule of thumb is that a one-half percent decrease in the pricing assumption translates into approximately a 15 percent increase in premiums. This puts considerable price pressure on sales. Because the rate filing approval process can take a year or longer, insurance companies are not capable of reacting quickly to drops in interest rates.

Sales production in general has declined in recent years. There is good evidence that the over 60 population may be saturated with offers of long-term care insurance. Younger individuals are less eager to purchase because long-term care is not an urgent concern. Without a strong marketing niche, consistent growth in this business may be a thing of the past for many insurance companies.

For insurance companies, the relief for unfavorable experience is premium rate increase. This relief is prospective only since losses from unfavorable experience are not recoupable according to insurance regulations. Because of the heightened sensitivity to rate increase filings, insurance regulators may only grant a portion of the amount of rate increases requested. Thus, for many insurance companies, the overall profit margins in their long-term care insurance line of business are significantly below what were expected.

Long-term care insurance policies issued after 2002 are generally governed by rate stability regulations. Under these regulations, the lifetime loss ratio formula can no longer reflect the actual investment results in the discounting. Because loss ratio is the measuring stick for rate increases, companies effectively assume all interest rate risks and are prevented from passing them along to the insured. Claims and persistency risks remain a shared burden for both the companies and the insured.

In recent years, the younger issue ages and the good persistency have extended the insurance companies' liabilities for a much longer period. In addition, future care delivery and societal changes will undoubtedly impact utilization of policy benefits. Perhaps it is becoming unreasonable to expect insurance companies to be able to predict all of the long-tailed risks accurately.

One recent development unrelated to long-term care is an additional concern. The United States is moving to a financial reporting system based on a market value valuation of liabilities. Changes in the valuation will be fully reflected on the bottom

CONTINUED ON **PAGE 22**

line at the time of change. Since a small change in assumption can produce a relatively large change in future liabilities, profit margins from long-term care insurance operation can be expected to be more volatile than they are today.

Confronted with low and uncertain future profits, lackluster sales growth and increasing difficulty in product risk management, it is not surprising that companies' commitment to this business is wavering.

UNIVERSAL LONG-TERM CARE INSURANCE

An alternative to today's level premium policy is to apply the universal life insurance design to long-term care. Just as universal life unravels the internal mechanism of a whole life policy, universal long-term care insurance breaks the traditional long-term care policy down into its various components. In this design, the insured person periodically deposits its premiums to an account in the policy. Costs of long-term care insurance and expense charges are deducted monthly from the account. The expense charges would be consistent with actual expenses incurred by the insurance company. The company credits interest to the account. When the policy lapses, the account value, less any surrender charge, is paid to the insured person or a designated beneficiary in case of death. The account is evaluated periodically to ensure that the policy will not lapse due to zero account value.

To lessen the likelihood that the policy will be outdated, benefits are flexible to better suit the claimant's particular situation.

To lessen the likelihood that the policy will be outdated, benefits are flexible to better suit the claimant's particular situation. The claimant and an independent care counselor collectively control the nature and manner of the care assistance and support that are most suitable for the claimant. There are virtually no restrictions on how the claimant can spend the benefit dollars. This benefit approach is similar to the Medicaid Cash and Counseling demonstration programs.

When there is no claim, the account value makes the policy flexible to meet the changing needs of the insured. Flexibility also extends to premium

Universal Long-Term Care Insurance Illustration

Policy Year	Attained Age	Monthly Benefits	Lifetime Maximum	Premium Deposit	Expense Charge	LTC Charge	Account Value	Level Premium
1	50	$4,800	$180,000	$1,600	$760	$14	$867	$1,600
5	54	$5,402	$202,592	$2,020	$565	$49	$6,908	$1,600
10	59	$6,263	$234,859	$2,703	$330	$103	$20,564	$1,600
15	64	$7,260	$272,266	$3,617	$422	$226	$41,705	$1,600
20	69	$8,417	$315,631	$4,841	$544	$501	$73,191	$1,600
25	74	$9,757	$365,903	$5,131	$163	$985	$118,057	$1,600
30	79	$11,312	$424,182	$5,131	$163	$2,240	$170,085	$1,600
35	84	$13,113	$491,743	$5,131	$163	$5,484	$223,276	$1,600
40	89	$15,658	$587,167	$5,131	$163	$16,429	$261,032	$1,600

deposits and benefit changes. Premium deposits are discretionary as long as the insurance and expense charges are properly funded. Changes in benefits affect only the future insurance charges. There are other positive effects as well. The insured would have greater confidence over today's policy because the internal funding for the insurance costs is transparent. Future increase in long-term care insurance charges due to unfavorable experience should be less frequent and for a lower amount because only claims experience can trigger it. Moreover, the account value should be able to cushion the increase for the near term.

In exchange for greater product flexibility and stability, the insured retain the investment return risk. This can be viewed as an advantage if the policy is a variable form, similar to a variable annuity. In this form, there will be a choice of investment options for the policy account.

The advantage of universal long-term care to the insurance companies is obvious. They relinquish virtually all the interest rate, persistency and expense risks. Managing the product is greatly simplified since only the claim risk is transferred to the companies. Unfavorable claim experience can be offset by implementing an increase in the long-term care insurance charges. With proper timing of the increase, the impact of adverse experience to the reserve liabilities in the new financial reporting system should be minimal.

In exchange for lower risk, perhaps insurance companies can strengthen the product appeal to the insured. Insurance companies could establish a schedule of maximum long-term care insurance charges so that the insured's potential downside is capped.

Universal long-term care would need to overcome several obstacles before it can be marketed successfully. The availability of the account value makes the universal long-term care insurance policy inherently more expensive than a traditional level premium policy with the same benefits. This exacerbates the affordability issue for long-term care insurance. The premium flexibility in the design can temper the higher premiums somewhat. For example, an increasing premium schedule can offer starting premiums that are attractive.

Refer to the illustration on page 22 of a universal long-term care policy with the increasing premium schedule along with a traditional level premium policy. Note that the projected values in this illustration will most certainly be different than those in an actual policy illustration.

In this illustration, the starting premium deposit is the same as the level premium for a comparable traditional policy. The premium goes up 6 percent each year until age 70 where it then becomes level thereafter. The increasing premium schedule is consistent with the increasing benefits and with the general increase in ability to pay while the insured person is working. The schedule results in a substantial account value in later years to fund the rising long-term care insurance charges.

Another issue for universal long-term care is that the insured must pay attention and plan for additional premiums if necessary to continue the coverage. Insurance companies must inform the insured in a timely manner.

Still another challenge is market inertia. The market is usually slow to adopt new concepts. Universal long-term care is more complicated to explain than today's policy. Educating the agents and getting their buy-in will be formidable tasks.

Regulatory Matters

From a state regulatory perspective, insurance departments are already reviewing filings on annuity and long-term care hybrid policies. Universal long-term care insurance is such a policy with periodic premiums rather than a single premium. Regulations for policy illustrations can mimic that for universal life.

From a federal taxation perspective, the Pension Protection Act of 2006 bifurcates an annuity with long-term care benefit into two separate contracts. Universal long-term care insurance would most likely be treated favorably under this scheme.

CONTINUED ON **PAGE 24**

Two ideas have been advanced to make universal long-term care more attractive to the consumers. First, the premium deposits can be lowered by restricting the surrender provision. For example, full surrender is permitted prior to attained age 75. Thereafter, surrender can only be in the form of a life annuity. This provision would dramatically reduce the cost of paying the account value upon death.

Another idea is to make universal long-term care a part of 401(k) programs (or similarly tax-favored accounts). Conceptually, the policy account of a universal long-term care insurance policy operates as a subaccount in the 401(k) program. One can argue that 401(k) is the natural venue because long-term care financial protection is merely a component of retirement security. Funding for the universal long-term care within a 401(k) program is enticing since it would simply be an allocation of the existing assets in most cases rather than competing for discretionary spending dollars. This approach would require federal legislation and would be perceived as a very helpful gesture from the government to promote private long-term care insurance.

A tipping point may be fast approaching for the long-term care insurance industry. Insurance companies are questioning the role of long-term care insurance in their strategic plans. More of them may exit once the new accounting standards are adopted. Those remaining may not be eager to take on all the risks embedded in today's policy. Potential buyers are also disillusioned. The third stakeholder, namely, the policymakers, should be concerned about the future viability of the industry.

Universal long-term care is not a panacea for all the problems facing the industry. It can provide a reasonable option for the buyers and the insurance companies but it does little for the in force business. Nevertheless, among the efforts to revitalize the long-term care insurance market, it deserves a look.

Note: *This is an abridged version of "Deconstructing Long-Term Care Insurance." The article, in its entirety, is available online at* http://www.soa.org/ltc. ■

END NOTES

[1] Both the return of premium upon death and the non-forfeiture options in many of the policies provide some form of cash value but few buyers elected them.

[2] Nearly all new entrants are life insurance and annuity companies. They are including long-term care benefit options in their single premium life insurance and annuity contracts—the so called hybrid policies. These policies require substantial premium (typically over $50,000 single premium), need for dual protection (long-term care and death), or both. They will probably have a difficult time penetrating the main segment of the long-term care insurance potential market—the working and the pre-retirement populations.

[3] This illustration is for an individual issue age 50 in the Married–Standard risk class. The policy has a $160 initial daily benefit, a 5-year maximum benefit period, a 90-day elimination period and the benefits increases 3 percent compounded annually. Premium increases 6 percent annually to age 70 and level thereafter. Coverage ends at age 100. The policy has a 25 percent premium charge from year one through year five, 10 percent from year six through year 20 and 2 percent thereafter. In addition, there is a $200 initial charge and a $60 annual charge. The account value is accumulated at a 5 percent declared annual credited interest. The level premium is the average premium for a similar policy offered by a number of insurance companies.