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Long-Term Care Product Design: Two Common-Sense Recommendations

by Ed Mohoric

In the early days of long-term care insurance (LTCI), many assumptions were made regarding claim costs, lapses and investment returns. Many of these assumptions have proved wrong with the passage of time. The reasons are well known and much discussed within the LTCI industry. The result has been significant rate increases and, in many cases, an exit from the business by the insurers.

We have learned from the past (we hope); more appropriate assumptions are being made so that large rate increases should never be necessary on currently sold products. However, the problem now is that the products have become extremely expensive. A $200/day lifetime coverage plan with a 5 percent inflation benefit can easily cost a 60-year-old buyer over $6,000 per year. This is significantly impeding sales because a smaller percentage of the population can afford LTCI.

What follows are two modest design change ideas that—separately or together—could radically improve the value proposition for LTCI by lowering the cost of entry, which in turn could spur a new era of LTCI growth.

ASSUMPTION OF RISK: THE PROBLEM

LTCI is unique among mainstream insurance products in the amount of risk assumption that the insurance company accepts. Premiums are set based on assumptions for 60 or more years into the future, assumptions about utilization, longevity, cultural attitudes toward benefit use, expenses, lapses and investments. The insurance company sets a price that is expected to be locked in for the policy lifetime. No actuary can predict these assumptions with any accuracy—over time, the actual experience will either cause a loss (which has often happened) or a windfall for the company (which can also happen). The only adjustment that can be made along the way is to attempt a rate increase, which creates a whole new set of risks and issues—additional expenses, high marginal loss ratio, requirements for state approvals, slow implementation, anti-selection and reduced customer satisfaction.

LTCI is the only mainstream insurance product with this level of risk assumption (I exclude life insurance with low face amounts and hospital indemnity products, which operate in niche markets).

Specifically:

- **Casualty products:** Auto, homeowners and other casualty products are typically issued for one year. Upon renewal, the insurance company can adjust rates to reflect experience and/or refuse to renew individuals.
- **Major medical:** The premium guarantee here is also normally one year, and the insurer can adjust rates to reflect medical inflation, utilization charges, demographic shifts and group experience.
- **Medicare Supplement:** Similarly, premiums are adjusted annually for actual experience.
- **Universal life:** The product design allows adjustments in the cost of insurance (COI) charges, expenses and interest rates—often subject to a maximum charge or minimum guarantee. (Some recent universal life products have secondary guarantees that expose the carrier to similar long-term lapse and investment risks; however, many companies are redesigning these to reduce the level of risk assumed.)
- **Term life:** The premium changes periodically, which is due to age, minimizing the risk of lapse, and investment variance.
- **Annuities:** In fixed annuities, interest rates can be adjusted. In variable annuities, returns can be passed through to the insured. Longevity risk rates are not locked in until the time of annuitization.
- **Par whole life:** Dividends provide a buffer between conservatively priced products and adjustments for actual experience.

In all these other products, the insurance company assumes risk—as it should (that's its business)—but does not assume every risk to the degree assumed in LTCI. In all the other products there are adjustments that can be made to make the product more viable in different interest rate environments and as other future unknowns become known.

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DESIGN CHANGE #1: TRUE INFLATION ADJUSTMENTS

My first design proposal is to cover inflation by adjusting both the benefit and the premium for inflation as it occurs. As best I can determine, the current standard of the LTCI industry-- the pre-funded 5 percent annual inflation provision--was developed in the 1980s. Given the high inflation fears at the time, I speculate that the rationale was to provide some inflation coverage while protecting the insurance company from the risk of continual high inflation.

A 5 percent annual increase became the codified standard since the 1990s, though recently 3 to 4 percent increases have been available. This common product feature has several poor design characteristics:

- First and foremost it is wrong. A 5 percent annual adjustment could never be right, and it would only be coincidence if it turned out to be near the level needed. While recent, lower increases such as 3 percent may "seem" more right in today's world, they still are not right—inflation will either be more or less than 3 percent but it will not be a 3 percent annual amount.

Figure 1. Medical Inflation Changes

	CPI-U	Medical Care CPI-U	Nursing Home CPI-U
2002	2.4%	4.7%	4.3%
2003	1.9	4.0	5.8
2004	3.3	4.4	3.5
2005	3.4	4.2	3.5
2006	2.5	4.0	5.1
2007	4.1	4.4	4.9
2008	.1	3.7	3.2
2009	2.7	4.3	3.6
2010	1.5	3.4	3.2
2011	3.0	3.0	3.0

A more appropriate approach will be to tie annual increases to the consumer price index (CPI), the medical care index CPI or some other independent index. The actual annual benefit change will closely mirror the true trend. The initial purchased daily amount will be able to be compared with current costs and the worry about whether it's the right level for the future will diminish. (Is it really appropriate to ask the consumer to choose between a 3 percent and a 5 percent long-term inflation rate?) The table in Figure 1 summarizes the total CPI, the medical CPI rate and the nursing home/adult daycare CPI rate, over the last 10 years, based on the all-urban consumer price index (CPI-U).

- Annual funding: Because the "cost" of the CPI increase will not be pre-determinable, the price of inflation coverage will not be fully pre-funded. Annual premium increases according to a predefined formula will be used. The increases will be understandable and acceptable to the insured as they are tied to an index and are consistent with general inflation changes. The insurance company's risk on investments and on lapse is also lessened. ("Lessened" but not eliminated; there is still age pre-funding that will entail lapse and investment risk; also the slope of the benefit curve means there will still exist some pre-funding of the inflation benefit.)

- For the insured, the initial outlay is significantly less and is more appropriate. Individuals who happen to claim, die or lapse early are not funding for others' benefits; people who claim late will be assessed a fair amount—consistent with inflationary changes.

Because the pre-funding of inflation will be not be as significant under an annual funding approach, it will also reduce the level of early reserves and will therefore free up insurance company capital.

The chart in Figure 2 gives an example on how premiums may compare. Using reasonable current pricing assumptions, I illustrate the potential differ-

ent premiums for a $200/day plan purchased at age 60 using the last 25 years of the CPI (which averaged 2.9 percent). The initial premium for inflating premium CPI coverage is 57 percent lower than a plan that guarantees 5% benefit inflation using a level premium; the actual premium does not exceed the level premium until 35 years. Alternatively, if the 5 percent is reduced to the CPI level, the level premium drops by 37 percent—but even here allowing the premium to move with inflation produces an additional 32 percent reduction, and the actual premium does not exceed the level premium until 13 years.

The use of a predefined formula for changing the premiums—including for new issues—should allow companies to implement the CPI changes without re-filing the product with state insurance departments.

There is at least one company that currently offers a CPI rider in some states. The design is similar to a guaranteed purchase option that must be accepted annually. The price for the benefit increases is based on the issue age of the insured.

DESIGN CHANGE #2: TERM RATING

My second design proposal, which is likely more controversial, is to allow attained-age rates, similar to term life insurance. The potential controversy is likely not due to the concept but to the magnitude of change if fully implemented.

The impact of using term premium rates would be similar to non-fronting of the inflation coverage, but would be greater because age exerts more leverage. Where current annual inflation changes to premium would be expected in the 3 percent range, annual age adjustments to premiums would be 10 percent or more. This would allow the cost of entry to be much cheaper and would release significant reserves, but the annual change in premiums would be high. Consumers would need to understand the ultimate costs and may not be willing or able to pay them.

The chart in Figure 3 is an example of how the premiums may compare for an attained-age policy

Figure 2. Annual Inflated Premium

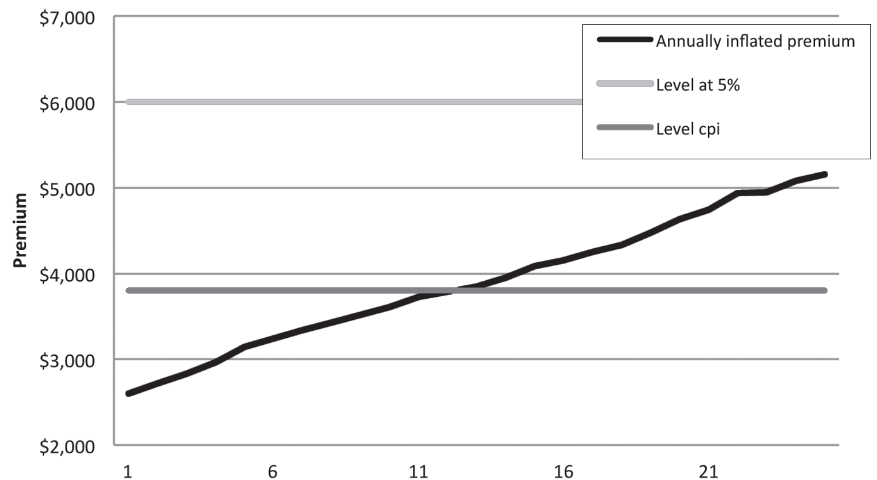
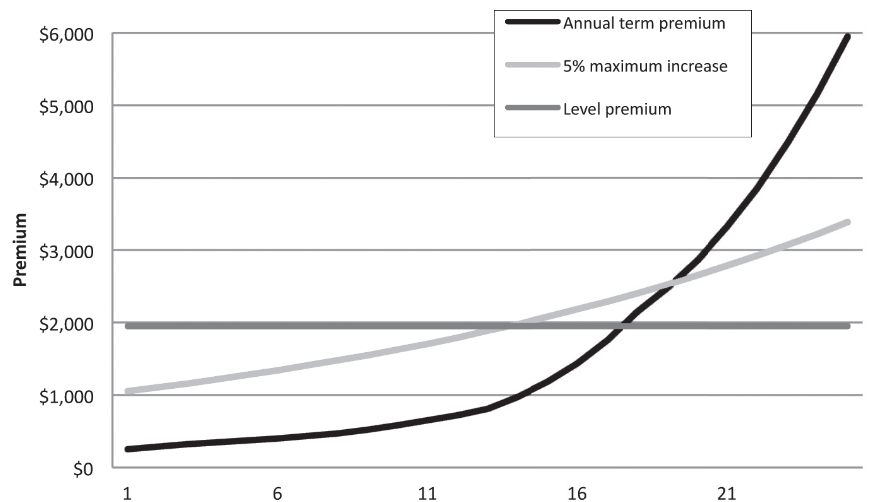


Figure 3. Annual Term Premium



purchased at age 60 (without inflation). The initial premium is only 13 percent of the level premium and does not exceed the level premium for 18 years. Term premiums cannot currently be used for LTCI plans because the Long-Term Care Insurance Model Regulation—a form of which has been adopted in most states—says in Section 6.F.(1) that "the premium charged to an insured shall not increase due to ... the increasing age of the insured at ages beyond

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65." Thus, only limited amounts of term pricing can be currently applied to the younger ages; in practice, it is not done.

This provision is included to protect consumers from increasing rates. However, this design restriction has contributed to the level of risk to insurance companies from making long-term assumptions regarding interest and lapses. Historically, this has added to the unplanned rate increase needs in recent years, which have been detrimental to consumers. With a term arrangement, the increases would be known and expected.

It is also out of step with the way LTC is priced within a combination product—where LTC coverage is added to a life insurance policy. These products have a de facto attained-age structure as the "premiums" are typically applied as term COI charges within the policy. (I note this would also be the structure that would be embedded in a universal LTC product, which has been proposed by many people over the years—most recently by Bob Yee in the May 2012 issue of *Long-Term Care News*.)

If the full annual increase is deemed too steep for consumers, rate safeguards may be added to reduce the annual increase or the ultimate level. For example, a product could:

- Limit the maximum age at which premiums may increase—say, to age 80 or 85
- Limit the annual increase to a smaller amount—say, 5 percent or 7 percent.

Either of these would necessitate some pre-funding, but would also create a product that has less investment and lapse risk than current designs, reducing the cost barriers to purchase. Figure 3 also shows that a 5 percent maximum increase by age would still allow for an initial premium that is a 45 percent reduction to a level premium and that would remain lower for 14 years.

Movement to an attained-age-rated product—or partially so—lowers the entry barrier to individuals. Of course, any changes in future premiums would need to be clearly illustrated and explained so the insured understands the implications.

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Both of these common-sense design changes have the combined attraction of being consumer-friendly while also reducing the level of risk assumed by the insurance company. Both represent a change from current industry design and practices; use of any attained-age premium beyond age 65 will require working with the National Association of Insurance Commissioners (NAIC) and state regulators to broaden permissible pricing designs. Similarly, the technical provisions within the "moderately adverse" actuarial certifications of the LTCI Model Regulation may currently prevent an index-adjusted premium.

However, the NAIC is starting to review the LTCI Model Regulation and may soon make some revisions. Given the recent state of LTCI sales and acceptance, now is the time to incorporate some changes that will reestablish this necessary product offering as a viable purchase. ■