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Facing Reality: LTCi Is Broken—Let's Fix It

By Roger Loomis

A few decades ago, we thought the ultimate lapse rate for long-term care insurance (LTCi) might be, say, 5 percent. That estimate proved to be high and contributed to severely underpriced products. We now price products with an ultimate lapse rate of 1 percent and sometimes lower. While low lapse rates cause consternation in the form of higher premiums, they do indicate how much consumers value LTCi.

The same cannot be said of insurers. From 2002 to 2013, the number of carriers offering LTCi has decreased from about 102 to 12[1]; over that 11-year time period, 17.7 percent of carriers left the market each year. While consumers see the value in purchasing LTCi, a shrinking few insurance companies see value in selling it.

This is surprising; there is an enormous need for LTCi coverage. So why aren't companies stepping up to the plate? Insurers who have exited the market have indicated they did so because the product is too risky, too capital-intensive, and too unprofitable.[2] In this article, I'm going to make a frank analysis as to why LTCi is so risky, capital-intensive and unprofitable. I will then make the case that if we rethink the fundamental way a stand-alone LTCi should work, it can be transformed into a vibrant product that is not only viable for insurance companies to sell, but also a better deal for consumers.

WHY LESS THAN 0.5 PERCENT OF AMERICAN INSURANCE COMPANIES SELL STAND-ALONE LTCI[3]

Insurance companies want predictable earnings. However, the income statements of LTCi blocks are inherently volatile. This is partly due to the way the products are designed, and is partly due to the way accounting rules operate. With LTC, every lapse, claim, death or recovery entails establishing or releasing a reserve (usually a large one), with profit serving as the balancing item. In all but the biggest companies, the statistical variance of lapses, claims, deaths and recoveries causes earnings to jolt from period to period like a bad rollercoaster ride. No wonder this product tends to make CFOs nauseous.

The more fundamental reason LTCi is risky, capital-intensive and unprofitable is because, as currently packaged, *LTCi risk isn't insurable*. There are six criteria a risk must meet in order to be insurable[4]:

1. **It should be economically feasible.** LTCi appeared to be economically feasible back when assumptions about low morbidity, high interest rates and high lapse rates led us to believe it would be affordable for the middle class. Knowing what we now know about these things, its economic feasibility is less clear.

2. **The economic value of the insurance should be calculable.** LTC dramatically fails to meet this criterion. As Ed Mohoric tersely explained, "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."[5]

3. **The loss must be definite.** There can be a wide, fuzzy line between being able to perform an ADL and not being able to perform it. The likelihood that you can't perform a set of ADLs seems to increase substantially if you have insurance and your friends have become residents in a nice assisted living facility (ALF).

4. **The loss must be random in nature.** This is the single criterion for insurability that I believe LTC meets—whether you need extensive LTC before you die might not be definite, but it is random.

5. **The exposures in any rate class must be homogeneous.** LTCi is subject to at least some anti-selection, so the exposure isn't homogeneous.

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6. **Exposure units should be spatially and temporally independent.** LTC fails this criterion in a spectacular fashion. Exposure to LTC risk isn't independent because it's a function of the elements that make it non-calculable (see 2 above). These unknowns about the future are statistically dependent and can't be diversified away by selling more policies.[6]

This brief analysis suggests LTCi is basically uninsurable. This is supported by the empirical evidence that so few companies are willing to sell it. When companies say LTCi is too risky, unprofitable and capital-intensive, what they are really saying is that it is uninsurable.

Insurance companies can't effectively manage uninsurable risks; such risks must be borne by either individuals or the government. However, I'm not going to suggest a government solution or a self-insurance solution. Rather, I'm going to suggest we change the basic framework of insurance policies so that the risk not only becomes insurable, but also becomes a better deal for consumers.

MUTUAL LONG-TERM CARE INSURANCE

The Ideal LTCi Policy

An ideal LTCi benefit design would have the following characteristics:

1. The premium would be fixed.
2. The benefits would be high in relationship to the premium.
3. Insurance companies would face low risk (and hence low capital requirements).
4. The insurance company's earnings would be smooth and predictable.

A product design with these features represents a win-win for policyholders and insurance companies.[7]

Here is a proposed policy design that seems to have all of these characteristics. I'm calling it "mutual LTCi."

Mutual Long-Term Care Insurance Defined

Purchasing a mutual LTCi policy entails entering into an insurance contract where you pay a fixed regular premium for life. As long as you continue to pay the premium, the policy remains in force (i.e., non-cancellable). The premium rate depends upon standard underwriting criteria.

In exchange for the premium, you receive a fixed number of shares in a fund. The net premiums are deposited directly into the fund, which is jointly owned by the policyholders. If you die or lapse, the money you have paid remains in the fund for the benefit of the remaining policyholders. According to how much money is in the fund and how many shares you purchase, you would be able to draw from the fund to help pay for LTC events. Like traditional LTCi, drawing benefits from the fund would be subject to activities of daily living (ADLs), elimination periods (EPs), benefit periods (BPs), maximum daily benefits, coinsurance, and so-forth.

The benefit available at the time of claim is simply the number of shares the policyholder owns multiplied by the per-share benefit level in effect at the time of payment. An actuary serving in a fiduciary capacity to the fund will recalculate the per-share benefit level annually. If the fund is doing exceptionally well, he may declare dividends. In all cases, the fund's performance accrues to its owners. The actuary's primary responsibility is to ensure the fund's solvency and the equitable treatment of the policyholders regardless of when they incur claims.

The reason this structure succeeds where traditional LTCi fails is because all gains and losses from lapses, death, morbidity and interest rates will accrue directly to the fund. The fund absorbs the gains and losses by adjusting future per-share benefit levels.

Some might argue that this places too much uncertainty on policyholders and defeats the point of insurance. I argue just the opposite: More than traditional LTCi, mutual LTCi has the hallmark of true insurance and is more faithful to the theoretical definition of insurance: "the insurance mechanism is used to transfer risk from the individual policyholder to the pooled group of policyholders represented by the insurance corporation. The insurance company administers the plan, invests all funds, pays all benefits, and so on. However, the insurance company can only pay out money that comes from the pooled funds."[8]

Why This Design Is Good for Insurance Companies

In mutual LTCi, the insurance company would be in the business of administering the plan, which entails underwriting prospective members of the plan, collecting premium, investing the assets, and adjudicating benefits. It would cover expenses and make a reasonable profit through the following fees:

- An administration fee deducted from every premium payment
- A fee for managing the assets in the fund
- A fee for adjudicating claims.

The insurance company enjoys predictable profits, low risk, and low capital requirements. This would attract competition into the market, which would keep profit margins low. The reserve is always equal to the assets, so management doesn't have to worry about wild swings in earnings every time there is a blip in claims or lapses.

Why This Design Is Good for Policyholders

The design is a winner for policyholders, too. Compared to traditional LTCi, the policies will be much less expensive for the same expected benefit level, and there is no risk of a rate increase. While policyholders won't know at issue precisely what the benefit level will be at claim, they will know that the benefit level will be more than reasonable in relation to the premium provided.

The public is naturally suspicious of traditional LTC policies because they recognize that the more an insurance company denies claims, the more money it makes. In mutual LTCi, this conflict of interest does not exist—the benefits associated with good morbidity are directly accrued to the policyholders.[9]

Major Action Is Needed

Changing the way we think about LTCi will be difficult for many. But if we don't face reality and make major changes to address a product design that is inherently uninsurable, then we should brace ourselves for the day when we wake up to find that nobody still sells stand-alone LTCi. Ninety percent of the insurance companies that have ever offered LTCi have left the market. The remaining 10 percent can't be far behind.

Long-Term Care Think Tank

The idea for mutual LTCi was inspired by the "Land This Plane" project, which is co-sponsored by the Long Term Care Section and the Forecasting & Futurism Section. In this project, a panel of 50 experts on long-term care (LTC) and aging is discussing the challenges of funding LTC in America, and is attempting to come to a consensus around a comprehensive solution. Our report will likely consist of specific recommendations for fixing Medicaid, designing a social insurance plan, and overhauling the private insurance market.

The electronic surveys used to solicit opinions from the panel are being opened up to a wider group so that we can get more ideas, more feedback, and greater consensus. If you have any feedback on whether mutual LTCi is the direction the industry should take, or if you want to weigh in on any other problem or proposed solution to the nation's LTC challenges, we cordially invite you to join the Think Tank. Please email either me *(Roger.Loomis@arcval.com)* or Ron Hagelman *(ron@rmgltci.com)* to join. ■

ENDNOTES

1 See Cohen, Marc A., "Factors Behind Carrier's Decision to Leave the Market" (session #37), 2013 ILTCI.

2 Ibid.

3 Based on an estimate, there are over 2,500 life and health insurance companies in the United States.

4 This list is taken from Dr. Robert Brown's *Introduction to Ratemaking and Loss Reserving for Property and Casualty Insurance, Second Edition,* pages 11–12.

5 Mohoric, Ed, "Long-Term Care Product Design: Two Common-Sense Recommendations," *Long-Term Care News*, January 2013, page 15.

6 The effect of future interest rates on independence merits extra attention. Future claims aren't financed by the net premiums alone, but also by the interest earned on the reserves. Interest returns are not statistically independent from policy to policy—all policies are subject to the same interest rate environment. The long duration of LTC liabilities exacerbates this lack of statistical independence.

7 Since one of the purposes of LTC regulation is "to promote the availability of long-term care coverage"(Long-Term Care Insurance Model Regulation, Section 1), a product design that creates a robust market is in the interest of regulators as well

8 Brown, page 13.

9 Technically, in mutual LTCi the carrier has the incentive to deny claims in order to grow the size of assets it is managing. However, this incentive is mitigated by the fee it earns by paying claims.

"… if we don't face reality … then we should brace ourselves for the day when we wake up to find that nobody still sells standalone LTCi."