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Recouping Past LTC Losses

By David Plumb and Robert Eaton

There has been a fair amount of industry discussion over the years about recouping past losses on long-term care (LTC) policies. Both insurance carriers and regulators are generally in agreement that LTC insurers should not be able to recoup past losses through premium rate increases. Prior to the 2014 NAIC LTC Model Regulation (the Model Regulation), this prohibition had not been uniformly regulated, and in fact past losses on LTC had not even been defined.

During the latter part of 2013, an NAIC actuarial task force worked with the industry on revisions to the NAIC LTC Model Regulation regarding premium rate increases. One topic that the task force addressed was ensuring that past losses are not recouped through rate increases.

One idea that was floated in those discussions was that past losses should be defined as past premium inadequacies given current, updated information. That view says that companies should have charged higher premium rates from the beginning, as if they knew then what they know now. The company's failure to charge the higher premium rate from policy inception, in that view, is deemed to be a "past loss" that cannot be recouped. The way of determining a "past loss" is perhaps intended to reflect an opportunity cost of not charging higher past premiums. In reality, though, there is no opportunity for a company to have this perfect knowledge from policy inception.

Under this view, a company could show in a rate increase filing that past losses were not being recouped by assuming the proposed increased rates had been in effect from the policy's issuance. The company could then demonstrate compliance with the loss ratio test[1] under this alternate scenario.

After discussion, the NAIC task force agreed that it is not realistic to define past losses in this way. This line of reasoning greatly expands the risk in the product, injecting additional pricing risk by not allowing companies to seek the appropriate premium levels needed to maintain the future financial health of the policies. This risk is particularly germane as the bulk of LTC claims on today's inforce blocks will emerge in the coming decades.

The following examples illustrate this risk:

1. We assume that actual experience is exactly in-line with original pricing expectations for the first 20 policy years. After 20 years, a new type of care emerges which is more expensive and more desirable than the prior care options. LTC carriers now expect that future claims will be more than originally anticipated in pricing. Those higher future costs need to be funded by rate increases.

   However, if the industry has to assume those higher rates had been charged in the first 20 years to satisfy the loss ratio test, the industry could suffer extreme losses.

Figure 1
Original Pricing Expectation

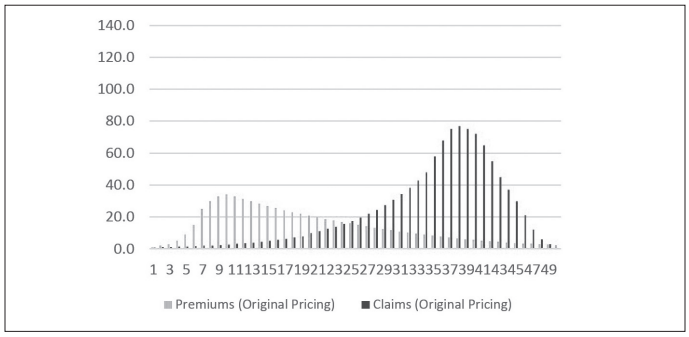


Figure 2
... with actual experience through duration 20

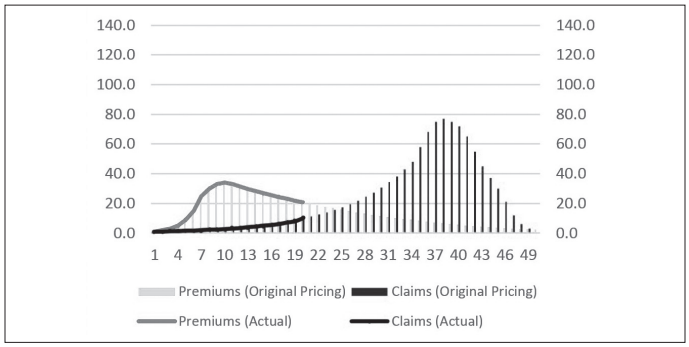


Figure 3
Original Pricing, Actual, and Projected Experience as of duration 20

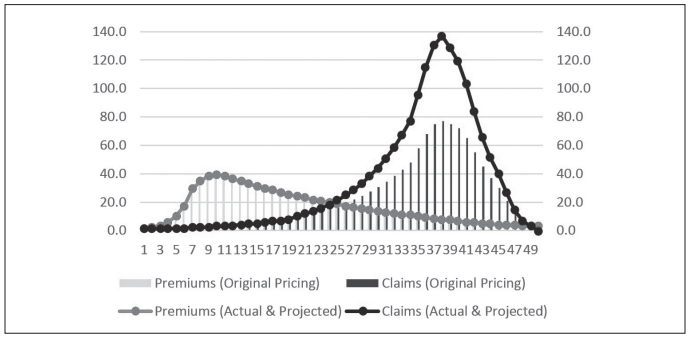


Figure 4

C. All premium rate schedule increases shall be determined in accordance with the following requirements:

(1) Exceptional increases shall provide that seventy percent (70%) of the present value of projected additional premiums from the exceptional increase will be returned to policyholders in benefits;

(2) Premium rate schedule increases shall be calculated such that the sum of the ***lesser of*** (i) the accumulated value of ***actual*** incurred ***claims,*** without the inclusion of active life reserves, or (ii) the accumulated value of historic ***expected claims***, without the inclusion of active life reserves, plus the present value of the future expected incurred claims, projected without the inclusion of active life reserves, will not be less than the sum of the following:

(a) The accumulated value of the initial earned premium times the greater of (i) fifty-eight percent (58%) and (ii) the lifetime loss ratio consistent with the original filing including margins for moderately adverse experience;

(b) Eighty-five percent (85%) of the accumulated value of prior premium rate schedule increases on an earned basis;

(c) The present value of future projected initial earned premiums times the greater of (i) fifty-eight percent (58%) and (ii) the lifetime loss ratio consistent with the original filing including margins for moderately adverse experience; and

(d) Eighty-five percent (85%) of the present value of future projected premiums not in Subparagraph (c) of this paragraph on an earned basis;

(3) *Expected claims shall be calculated based on the original filing assumptions assumed until new assumptions are filed as part of a rate increase. New assumptions shall be used for all periods beyond each requested effective date of a rate increase. Expected claims are calculated for each calendar year based on the in-force at the beginning of the calendar year. Expected claims shall include margins for moderately adverse experience; either amounts included in the claims that were used to determine the lifetime loss ratio consistent with the original filing or as modified in any rate increase filing;*

Figures 1, 2, and 3 reflect this block of policies initially filed with a 70 percent loss ratio calculated at the maximum statutory discount rate. Following the emergence of the new type of care, the actuary projects a lifetime loss ratio of 100 percent. The actuary determines the maximum allowable rate increase according to the "58/85" test found in the Model Regulation, and using the higher, originally filed 70 percent loss ratio as the basis.

Had the actuary been required to pass the test by applying a proposed rate increase to all historical periods as well, the loss ratio on the premium increase would be 365 percent. While the present value of claims would increase by 113, the present value of premiums would only increase by 31, meaning the company could only fund about 25 percent of the increased claims through premium increases.

2. A young block of business with lower issue ages has experienced modestly favorable claims for 10 years compared with the actuary's original pricing. The original pricing assumptions were based on industry data at the time the policy was first issued. Since that time, industry data have shown that ultimate voluntary lapse rates are likely to emerge much lower than originally anticipated. As a result, the actuary recommends an increase to premium rates for this young block of business.

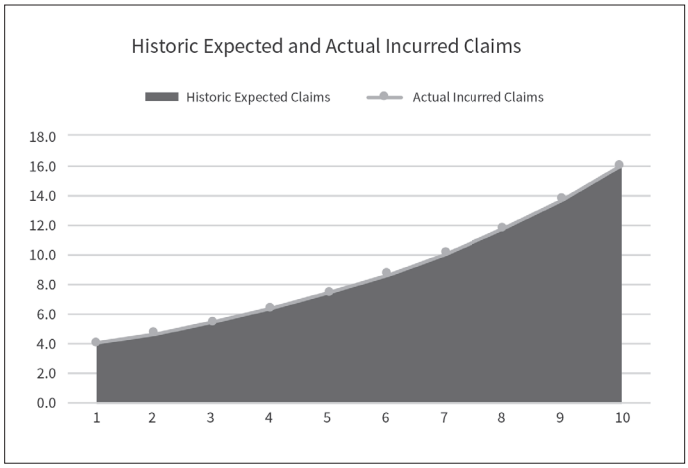
   The block of business has been closed for three years, and roughly half of the expected lifetime premium is in the past. If the actuary is required to pass the loss ratio test by re-stating all past premiums up to the proposed rate level, the allowable increase will be far lower and the company will suffer substantial future losses. This is true, in spite of the fact that there were no past claim losses on this block (in fact there were modest past gains).

Following much discussion, the NAIC task force decided that past losses should be defined as any excess of actual past claims over expected past claims. If a company has had years of claims losses and hasn't done anything about it, then those losses cannot be recouped. But if their losses are projected to be in the future as in the examples above, then there are no past losses. The portions (in bold italics) from Section 20.1 of the Model Regulation in Figure 4 illustrate how this concept ensures that past losses are not recouped through premium rate increases.

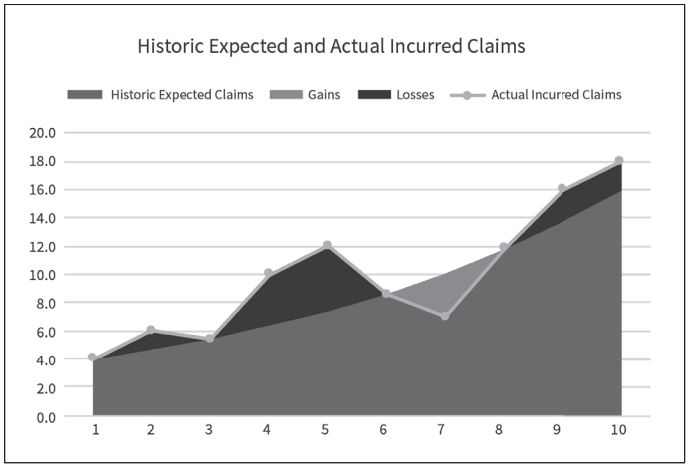
A numerical example, illustrated in Case 1, Case 2, and Case 3 demonstrates the application of this latest update to the Model Regulation. In each case an LTC actuary is considering re-pricing a block of policies that has not been re-priced in the past. To calculate the allowable premium rate increase according to Section 20.1, she examines the actual incurred claims and the historic expected claims based on the definitions above.

In each case the actuary must accumulate actual incurred claims and historical expected claims. Historical expected claims for a given year are based on original filing assumptions* applied to the policies inforce at the beginning of that year, including an expected margin for moderately adverse experience. Because the original filing* morbidity assumptions are applied to actual inforce policies, the expected claim calculation automatically adjusts for the actual persistency vs. the original filing* persistency assumption. Table 1 summarizes the three cases, and the past claims which may be used to determine the maximum premium rate increase.

Case 1
Actual incurred claims are equal to historic expected claims.



Case 2
Actual incurred claims are greater than historic expected claims.



Case 3
Actual incurred claims are less than historic expected claims.

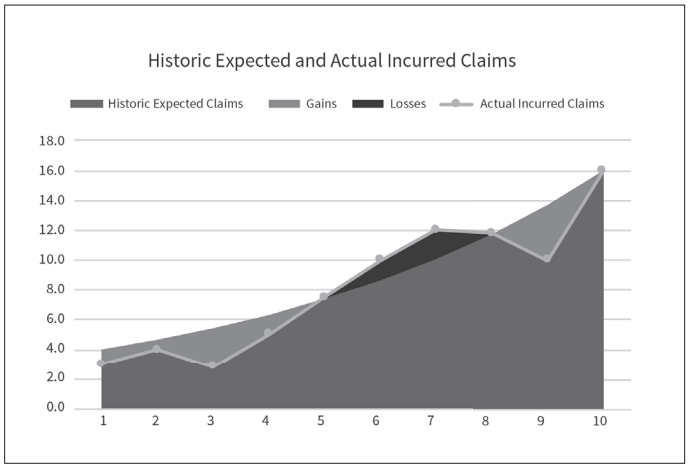


Table 1
Accumulated value at the end of year 10

Case	(a) Historic Expected Claims	(b) Actual Incurred Claims	Past losses	Lesser of (a) and (b)
1	100.7	100.7	0.0	100.7
2	100.7	113.5	12.8	100.7
3	100.7	93.3	0.0	93.3

In Case 2, there are past losses. The actuary is required to reflect the historic expected claims in determining the maximum allowable rate increase. This will produce a lower maximum rate increase than if actual incurred claims were used. In Case 3, where there are past claim gains, the actuary must reflect the favorable experience.

*In the calculation, the actuary must use prospective adjustments based on the assumptions established at the time of any prior rate filings.

POSSIBLE DRIVERS OF FUTURE LOSSES

Some companies today are finding themselves in the position that claims are higher than expected at the older attained ages and later policy durations. There are many reasons why this might be the case, including:

- The company's underwriting may have been better than originally expected. The company will not start to recognize its ultimate claim levels until this underwriting has worn off, and more policyholders reach the older attained ages. While a company may have years of favorable claims due to this good underwriting, they may be only starting to see what claims will be like at the older ages and later durations as the business matures.
- Companies may observe higher persistency, both in the form of lower mortality and lower voluntary lapse. This may result in more future claims and premiums. Since LTC claims are typically incurred in later durations while LTC premiums are earned mostly in early durations, this could cause a future loss scenario.
- New technology and innovation will likely produce LTC methods, institutions, and devices which insurers could not have anticipated at the time of original pricing. If policyholders prefer these innovations, and they are more costly than traditional LTC care, then current premium rates may be inadequate to fund future claims.

Each of these scenarios indeed reflects future losses, not past losses, and the 2014 NAIC Model Regulation appropriately treats them as such. ■

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ENDNOTES

1 Long-Term Care Insurance Model Regulation, Section 20 C and Section 20.1 C, http://www.naic.org/store/free/MDL-641.pdf, accessed Jan. 18, 2017