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Long-Term Care Insurance at a Crossroads

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After forty years of sales and seven million policies in force[1], the long-term care insurance (LTCI) market has become stagnant. Sales have precipitously dropped and many insurance companies have exited the market. Market penetration is barely at 10 percent of the buying population.[2] Moreover, policyholders are facing large premium increases due to actual experience being worse than anticipated. From the consumer's perspective, the value proposition of LTCI is unclear since the ultimate cost of insurance is undetermined. Single premium policies that combine life insurance and long-term care coverage have supplanted traditional LTCI in the high-income segment of the market; however combination policies have not penetrated into the rest of the market thus far.

Despite this downturn, the need for insurance protection against the financial risk of long-term care is as great as ever. With the repeal of the Community Living Assistance Services and Supports Act and proposed cutbacks in other health and welfare programs, the federal government has shown little appetite to provide insurance protection. Yet the aging population and rising costs of care demand viable financing solutions. Since not every senior will require long-term care services in his or her lifetime, the sharing of risk through insurance remains a cost-effective approach to fund these potential services.

The LTCI industry has arrived at a crossroads: it can continue to decline, or it can resolve the aforementioned issues to become a vital component of long-term care financing again.

HOW DID WE GET HERE?

In order to solve to these issues, it is helpful to understand the key forces behind the industry's present predicament. Similar to other consumer products, private insurance operates under the precepts of free enterprise: companies are free to offer products and consumers are free to purchase them, with laws and regulations in place to ensure a fair balance between both parties' interests.

Insurance companies began offering LTCI in the form of nursing home insurance in the mid-1970s when they recognized a demand for protection from the high costs of institutional chronic care. Virtually all other health insurance available at that time covered only acute care. Nursing home insurance paid a fixed daily sum for nursing home stay for a defined period of time. Coverage continued for the lifetime of the policyholder as long as premiums were paid. Premiums were adjustable, but subject to regulatory approval. The purchasers were mostly retirees over age 65. Compared to today's LTCI policies, nursing home insurance had a simpler design and the risks to the insurance companies were better contained.

Appropriately so at the time, nursing home insurance was regulated no differently than other forms of health insurance.

A major provision in health insurance regulations is the minimum loss ratio requirement. To ensure that policyholders receive adequate benefits, claim payments must meet a minimum percentage of the premiums over the lifetime of policies under the same policy form. For LTCI, state regulations generally require that claims payments be at least 60 percent of the premiums over the lifetime of a policy form, which usually lasts more than 40 years. Loss ratio requirement recognizes the uncertainty of future insured events. It allows for premium adjustments to maintain a reasonable relationship between claims payments and premiums. It follows that the insurance company and the policyholder enter a LTCI contract (approved by the regulators) under an implicit agreement on the required relationship between expected claims payments and premiums throughout the life of the contract.

The loss ratio requirement has worked successfully for many types of health insurance such as medical insurance, where claims are frequent and premiums are annually calibrated to recent claim experience. It has been less successful where claims are initially low, but increase with time, and premiums are intended to be level. In the case of LTCI, the probability of claiming benefits at age 60 is approximately 0.13 percent, but increases to 6.4 percent at age 85,[3] which corresponds to a 50-fold increase. Unlike the early nursing home policies, LTCI policies are typically sold to individuals in their late 50s to early 60s; however, claims generally do not commence until policyholders reach their late 70s. In addition to claims, the financial outcome for insurance companies involves long-tailed risk factors that are typically not found in short-term insurance coverage. These include mortality, lapse, investment yield, and long-term care service cost inflation over the lifetime of a policy form, all of which are difficult to accurately predict over a long period of time. The total amount of claims paid is heavily influenced by these factors.

The popularity of LTCI began to rise in the 1980s. Many insurance companies entered the market buoyed by market potential and favorable early claims experience. Competition in price, product features and sales compensation spawned healthy sales growth. Home health care and assisted living facility benefits were added, as well as the option for unlimited lifetime benefits. With very limited experience on the population of policyholders, these features represented additional risks to the insurance companies. They also attracted younger buyers, which compounded the risks due to longer period to claim. The loss ratio requirement allowed certain companies to justify competitively low premiums since a relatively small change in assumption (for example, lapse rates) could significantly impact premiums. Certain insurance companies decided that aggressive pricing and untested policy features were acceptable risks, because the initial prices could be corrected by future premium increases if necessary. At the same time, the loss ratio requirement assured regulators that, in the long run, sufficient benefits would be paid relative to the premiums charged.

In the industry's infancy, the long-tailed risk factors underlying the LTCI product were not well appreciated. Experience data on LTCI were not available in the public domain due to company privacy protection. Many company managers and outside consultants had health insurance backgrounds, but lacked expertise in assessing the financial impact of long-tailed risk factors. Likewise, many regulators with health insurance experience were not fully knowledgeable about LTCI. With a lack of available experience data, these regulators were not able to accurately assess the validity of the assumptions supporting the premiums. Moreover, claims experience emerged slowly due to low claim frequencies in the early years. During this time, loss ratios were well under the targeted 60 percent,

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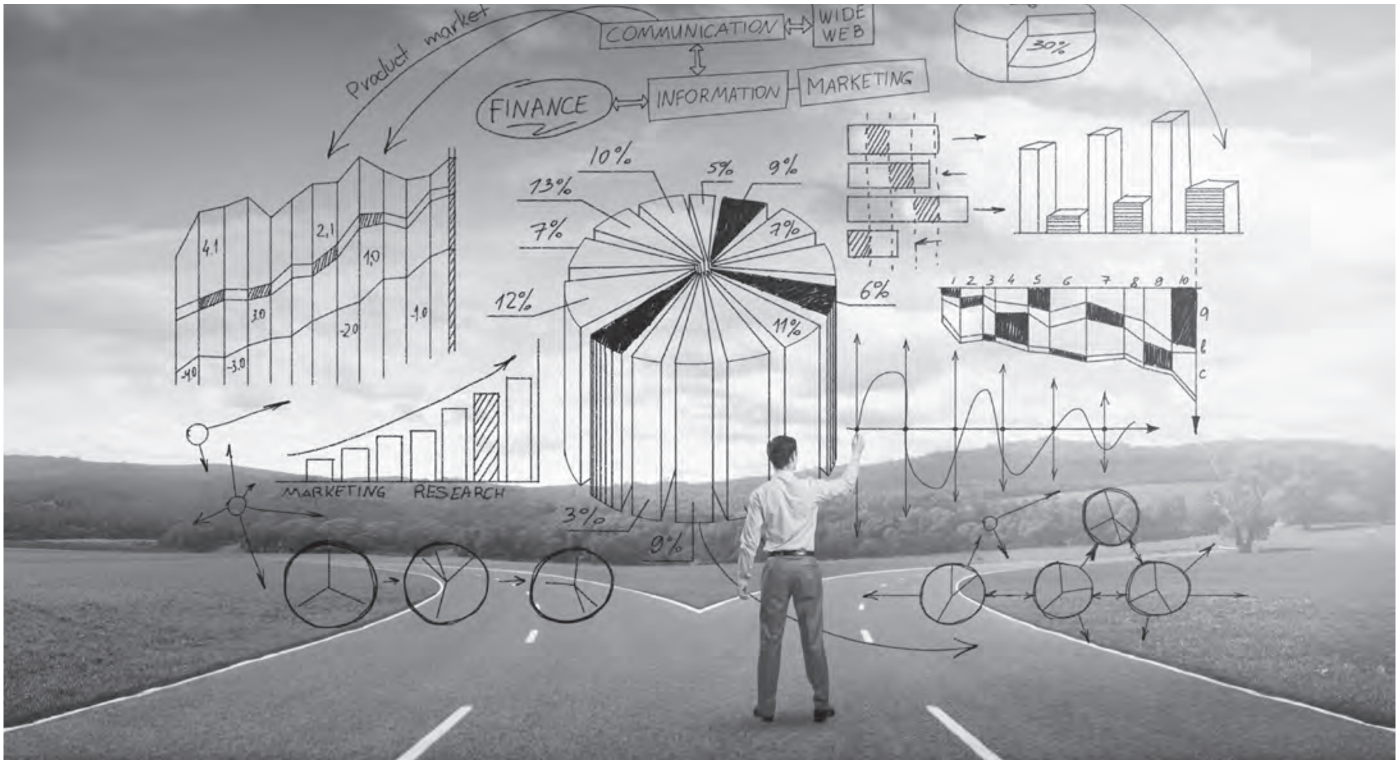
imparting a false impression of premium adequacy. Until more credible experience data and better techniques became available, projection of these long-tailed risk factors was based more on judgment than actual data. Sound insurance practice relies on a relatively high probability of realization, but at this stage, insurance companies were effectively gambling in a situation where the probability of success was not well quantified. Nevertheless, the marketing forces for LTCI created an environment for growth exactly as a free enterprise system intended. The loss ratio requirement ensured competition for the best perceived value to the consumers in terms of prices and attractive policy features.

In the 1990s, the thriving LTCI market began to unravel when claims in older policies exceeded the expected claims set forth in the original development of the premiums. Insurance companies realized that more policies in LTCI were persisting than in other health products such as hospital indemnity and Medicare supplement insurance. High persistency was also due to improvement in mortality and policyholders' perception of the increasing value of their insurance protection as they aged and their health declined. More policies persisting would result in



more future claims than anticipated. In addition, claims data suggested higher claims frequencies at older ages and longer stays in assisted living facilities. In more recent years, investment yields were lower than anticipated. In sum, emerging experience on all the risks factors was unfavorable, which had grave consequences for regulators, insurance companies and policyholders.

Due to the adverse experience, the original premiums at time of issue have been inadequate to cover future claim costs. Since the loss ratio requirement applies to the entire lifetime of a policy form, the burden has been placed entirely on the in force policyholders, who must cover their own premium deficiency as well as any deficiency of policyholders no longer in force. Consequently, large premium increases have been generally necessary to restore the lifetime loss ratio to 60 percent, especially for older policy forms. Regulators have been understandably reluctant to impose such increases on policyholders, many of whom are retired with relatively fixed income.

To lessen the burden on policyholders, several states have arbitrarily restricted the amount by which premiums can increase, even though larger amounts are warranted by the 60 percent lifetime loss ratio. However, as the number of policyholders decreases due to lapse and death, restricting the premium increase has only served to raise future premiums for a smaller number of future policyholders. As previously noted, credible claims experience emerged slowly and assumptions of future events always involved an element of judgment. Thus, it has been challenging for regulators to accept insurance companies' justification for requested premium increases, and these assumptions have been frequent points of contention between regulators and insurance companies.

From the regulator's perspective, premium increases may be considered a privilege rather than a contractual right. It is a privilege to serve the policyholders who have entrusted the insurance companies for protection. They contend that insurance companies should be held responsible for the mispricing. Certain insurance companies argue that the loss ratio requirement exerted downward pressure on original premiums that the regulators approved. Insurance companies issued LTCI contracts with an expectation that loss ratio standards would apply throughout the terms of the contracts. However, necessary premium increases have not been granted, effectively resulting in breaches of contract. Disagreements over premium increases have eroded the trust between insurance companies and regulatory bodies. Furthermore, as premium increases are denied, reduced or delayed, insurance companies face substantial financial losses. At least one LTCI company has become insolvent and others may share the same fate in the future without timely premium relief.

In the early 2000s, insurance companies began to exit the LTCI business when the potential rewards were no longer commensurate with the financial risks. Company management recognized that the long-tailed risks were extremely difficult to manage. Instead of improving the financial performance of a block of business by repricing new business, management limited its potential losses by ceasing new sales. However, companies cannot terminate their existing blocks of business as long as premiums are paid. In conjunction with exiting the business, a number of publicly traded insurance companies recorded losses in their financial statements by strengthening their reserves. This resulted in little or no expected future profits, but further deterioration in experience would lead to future losses. Insurance companies also recognize that an under-performing closed block of business would be a drag on future earnings, financial rating, and stock price.

Considering policyholders as a group, they have collectively been receiving significantly more claims payments than were anticipated in the original premiums. Therefore, the argument for premium increases that correspond to higher claims may seem reasonable. However, as individuals, many policyholders can ill-afford the large premium increases. Even with large increases, there is no assurance that premiums will be stable in the future. At the same time, many find their insurance protection increasingly valuable due to declining health, so lapsing the policy is not desirable. It is a disservice to policyholders not to inform them what the ultimate premiums may be. If provided with appropriate information and guidance, policyholders may be able to make better decisions regarding the premium increases. Also, the heightened risk of company insolvencies, which would reduce their insurance protection, has not been disclosed. Thus consumers' confidence in the industry may well be vanishing.

The industry is facing enormous challenges on both new and in-force business. Even when sizeable premium increases can generally be justified based on loss ratios, regulators are reluctant to grant them. Delays in premium increases will likely result in larger increases in the future for the remaining policyholders. Few companies are left because the underlying risks in the current product structure and features are unacceptable. In the meantime, policyholders face uncertainties and a lack of transparency in their insurance protection.

WHERE DO WE GO FROM HERE?

There was no single party or event responsible for the current predicament of LTCI. Rather, this crisis is a byproduct of an imperfect free enterprise system. In retrospect, it is doubtful that the early proponents of LTCI could have had the foresight to avoid the pitfalls known today. The industry needs to reflect on its achievements, recognize its mishaps and shortcomings, and resolve to improve.

Despite its shortcomings, the LTCI industry has made modest strides in protecting the public from long-term care financial risks. More than seven million policyholders are currently covered; over a quarter million policyholders received benefits during 2015 alone.[4] LTCI can help lessen the burden of Medicaid on future generations by preventing policyholders from becoming Medicaid beneficiaries. As such, it is generally recognized that private insurance will play an important role in LTC financing irrespective of any future government involvement.

Due to the convergence of multiple unfavorable outcomes, large premium rate increases have been filed and will likely to continue in the future. An agreement on the responsibilities of the insurance companies and policyholders on premium adequacy can stabilize the in force business. This market is hardly mature, as the need for the product remains strong. If there is new vigor in the marketplace, an additional 20 million individuals may be insured in 20 years assuming a 30 percent market penetration in the buying population.[5]

The very nature of long-term care is based on the notion of caring in a community. At home, family members or hired aids assist elders. In nursing homes, staff members are responsible for the wellbeing of residents. The LTCI industry is a community, with the insurance companies and regulators striving to serve the best interest of the policyholders. If insurance companies and regulators focus on the spirit of caring for seniors, the industry will surely follow the right path at the crossroads. ■

Disclaimer: The views expressed herein is that of the author and not of his employer. This is the first of two articles regarding the issues in the long-term care insurance industry. This article examines the forces that created the current state of long-term care insurance. The second article describes several ideas to revitalize the industry.

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ENDNOTES

1 Long-Term Care Insurance Experience Report for 2015, National Association of Insurance Commissioners, page 7.

2 For the purpose of determining market penetration, the buying population is defined here as the group of relatively healthy heads of household ages 45 and over with income above $35,000 and their spouses. Data is based on *U.S. Census Bureau Household Income in 2015*, Tables HINC-03.

3 Incidence rates from the Society of Actuaries' Long-Term Care 2000-2011 Intercompany Experience Study.

4 Long-Term Care Insurance Experience Report for 2015, National Association of Insurance Commissioners, page 7.

5 Estimate based on 2010 Census population projection by age.