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To Cede or Not To Cede: Overcoming the Hurdles to Ceding Legacy LTCI Risk

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For insurance companies with legacy long-term care insurance (LTCI) blocks, whether or not to cede that risk is becoming an increasingly important question. More than a few LTCI issuers active in the 1990s and early 2000s would benefit from such ceding, as these portfolios are generally low-profit or unprofitable and keep capital tied up that might be better deployed otherwise.

These deals, however, could involve several significant hurdles. Here are some:

1. **Negative ceding commission.** Mutually agreeable transactions are becoming increasingly difficult to craft. Even as recently as ten years ago, insurers that sought to cede their legacy LTCI risk expected to be paid outright or to do so at little cost to them. That is no longer the case: an LTCI cedant now must be willing to pay to offload the risk.

2. **Policy language.** Legacy LTCI policy forms language was for the most part far less clear than today's language. That lack of clarity has resulted in higher benefit payouts for these older legacy policies, as claims decisions in the past (and likely into the future) have favored more liberal interpretations. This has contributed to the poor performance of these portfolios and may negatively impact valuation.

   For example: the original pricing may have assumed that benefits would only be restored if a policyholder recovered fully, but the actual policy provision language may only have required that the policyholder cease receiving formal care for 180 consecutive days. Essentially, insurers had issued LTCI policies with nearly unlimited benefits, limited only by six-month intervals when benefits are not paid.

   Because of this disparity between pricing assumptions and policy language, making a calculation of future risk is more difficult to shape.

3. **Original underwriting concerns.** An assuming company may be concerned whether long-term risks could exist due either to weak underwriting or past underwriting exceptions. Underwriting exceptions are a clear danger: they can mean higher overall claims experience as well as risk that could impact performance well into the future.

   LTCI underwriting has become stronger over the past few decades, so an assuming company may want to consider the strength and effectiveness of the original underwriting relative to the existing underwriting tools and underwriting conventions in the market at the time, to determine if there may have been more or less potential for adverse selection.

4. **Investment income.** If cedant and assumer investment and interest rate expectations are too far apart, a deal may not happen. The ceding company is often invested in long-term debt instruments purchased back when yields were higher, and the company assuming the risk will need to invest assets at current new money rates. This means an assuming company would have to invest a larger amount in lower-yielding instruments or choose riskier, higher yielding instruments in order to achieve investment yields that will support the block. Holding riskier assets, however, means holding more capital, raising the cost to cede.

5. **Differences in persistency assumptions / expectations.** Even though legacy LTCI lapse and mortality rates are generally substantially lower than had originally been assumed, differences between a ceding and assuming company's persistency assumptions and expectations can still occur. Policies with weaker underwriting might reasonably be expected to have had higher mortality as well as morbidity risk, and policies with more comprehensive benefits or with automatic increasing benefits might experience even fewer lapses. If an assuming company and cedant have substantially different persistency expectations—specifically, if the assuming company believes the business will have significantly higher persistency than does the cedant—a deal may not be possible.

6. **Premium rate increases.** New rate increases along with the accumulation of past rate increases can often have an impact. Even if state approvals of premium increases were not a concern, policyholder behavior could still be a wild card, particularly if multiple past rate increases have been implemented. Some assuming companies may reasonably believe that more premium increases, either in count or amount, may prompt even more claims incidence or longer use of benefits. Multiple premium increases may also prompt adverse selection, perhaps with even more of the healthier policyholders lapsing their policies or reducing their benefits ("partial lapses"), and those expecting to file claims keeping their original benefits. Partial lapses may require an assumption of higher utilization, where utilization is the percentage of actual expenses being

reimbursed by the policy relative to the maximum payable by the policy in a given period.

7. **Rating agency / investment analyst perspectives.** Often, rating agencies and analysts view it positively when an insurer cedes its legacy LTCI risk. Not only does it free up capital for higher-profit investments, it also takes away the negative perception that accompanies legacy LTCI business. Unfortunately, that negative perception is frequently a hurdle for the assuming party, which may need to explain to the rating agencies and investors why assuming legacy LTCI risk is suitable for its risk portfolio.

8. **Reserve credit.** When ceding business, statutory accounting principles require that 100 percent of the risk be transferred to the assuming party in order for the cedant to reflect reserve credit. This full transfer of risk can be a hurdle, because it means that an assuming company cannot restrict the benefits it reimburses.

9. **Cedant counterparty exposure.** A cedant will require assurance that the assuming company is well managed and financially strong. If the assuming company lacks the financial or management strength to carry and administer the assumed risk long term, the cedant may have to recapture the risk, and at the very least, would suffer reputational damage with investors.

10. **Administration.** In this case, the assuming party will have the hurdle. The cedant may be a counterparty risk for the assuming party if the cedant continues to administer the business and adjudicate claims, instead of either retaining administration or using a third-party administrator. In either case, the assuming company would need assurance that the business will be administered effectively and according to the terms of the policies. If an administrator fails to fulfill expectations, the assuming company would likely face additional expenses or liabilities in order to correct the problem.

    The assuming party may want to establish clear parameters in advance. Disagreements will arise over issues such as eligibility of a claim, fraud, or administration, and the assuming company will want to minimize or avoid such surprises. Needing to address these matters may delay or discourage a potential party from assuming the business.

Any one of these obstacles may be hurdled, but trying to jump over them all without tripping can be a challenge. ■

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