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Long-Term Care Insurance Needs a Reboot

By Bob Yee

(Note: The view expressed herein is that of the author and not of his employer. This is the second of two articles regarding the issues facing the long-term care insurance industry. The first article, "Long-Term Care Insurance at a Crossroads," published in the August 2017 issue of Long-Term Care News, *examined the forces that created the current state of long-term care insurance. This article describes several ideas to revitalize the industry.)*

The long-term care insurance (LTCI) industry is at a crossroads, as managing long-tailed LTCI risks has proven to be extremely challenging. The industry's predicament arose because premiums for most in-force policies, developed using optimistic assumptions, are not sufficient to pay future benefits. Consequently, large premium increases are necessary to cover future claims, but difficulty in obtaining state approvals for the increases has led to substantial financial losses for LTCI companies. Because experience develops slowly, insurance companies have been requesting multiple rate increases over time. Furthermore, experience may change in the future; thus, there is no guarantee that increases will subside. Although policyholders value their insurance protection, premium increases are becoming unaffordable for many who are retired and living on a relatively fixed income. Negative publicity from rising premiums has resulted in plummeting new sales in recent years. Lastly, few new product designs to reduce risks to the insurance companies have been forthcoming.

This article explores several ideas about in-force management and product innovation that may help the industry to reboot, in order to continue protecting Americans against the financial risks of long-term care.

WHY NOW?

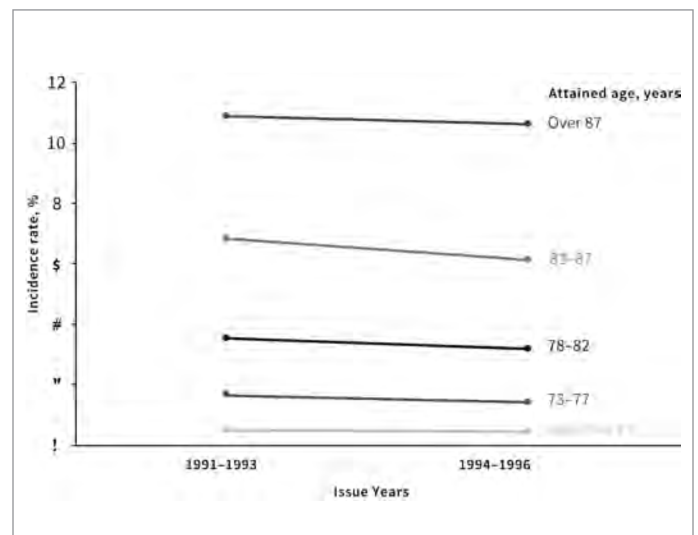
The current dire situation will only worsen until the industry takes corrective actions. Insurance companies have the contractual right to request premium increases and state insurance laws allow them, subject to approval by state insurance departments. The simple fact is, the longer it takes to implement the necessary premium rate increases, the larger future rate increases will be. Dragging out the increases puts increasingly heavy burdens on future policyholders. As the amounts of approved premium increases vary materially by state, policyholders are being treated unevenly.

The costs of LTCI company insolvency are generally first distributed among health insurance companies, but ultimately passed on to their customers in the form of higher premiums. There is already one insolvent LTCI insurance company and industry experts are concerned that other insolvencies will occur in due course. It is unclear to what extent LTCI insolvencies will harm the entire health insurance industry, especially smaller health insurers.

A positive development in the face of uncertain future premiums and potential LTCI insolvency is that prediction of LTCI experience is now more reliable than before. In the past, the slow development of experience data (due to relatively low annual claims incidence rates during the early policy years) coupled with a scarcity of industry-wide information have resulted in the inaccurate projection of financial results and erratic demands for premium increases. With over thirty years of history, the industry now has accumulated sufficient credible claims data to better estimate future experience.

In particular, claims incidence experience appears to be stabilizing, perhaps because product features and underwriting standards have become more uniform. Figure 1 illustrates this finding.

Figure 1
Society of Actuaries' 2000–2011 InterCompany LTC Study: Aggregate incidence rates for policy durations over 15 years



Based on over 4,500 claims from the Society of Actuaries' 2000–2011 Long-Term Care Experience Study, claims incidence rates for policy years 16 and over for two groups of policies issued between 1991–1993 and 1994–1996, respectively, by attained age group were compared. The incidence rates were level or slightly declining in all the attained age groups.

Besides incidence of claims, the LTCI industry has gained considerable knowledge of other risk factors that drive its economics, including claim termination, lapse, mortality, investment return, and expense. The rates of claim terminations have been steady as assisted living facilities are firmly entrenched as an alternative to nursing facilities. The ultimate lapse rate in later policy years, an important assumption in the estimation of future events, is turning out to be approximately one percent, which narrows the range of adverse variability. In a persistent low interest rate environment, prudent estimation of future investment returns would likely be conservative. The industry has learned that mortality experience, especially at older ages, is similar to annuitant mortality.

Future claims trends are still largely unknown, but advances in medicine (e.g., abatement of dementia) and technology (e.g., robotic aids for home health care) are likely to reduce future overall claims expenses rather than increase them. That said, these slowly emerging trends may have little impact on the future experience of many policyholders who are now already in their 80s.

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This newfound confidence in quantifying the risk factors, together with improved analytical techniques, has made future LTCI experience more predictable. With proper margins for adverse deviation, a number of insurance companies now can determine the premium increase sufficient to fund future liabilities with a low probability of additional increases.

IN-FORCE MANAGEMENT

The lifetime loss ratio requirement has been the standard by which LTCI financial obligations between insurance

companies and policyholders are demarcated. Under this requirement, 60 percent of the premiums (in almost all states) are returned to the policyholders in the form of benefits over the lifetime of a group of similar policies. This requirement has worked reasonably well for other forms of health insurance where credible experience develops fairly swiftly and premium rate adjustments are frequent. For LTCI however, slowly emerging unfavorable experience in later policy years that differed from what was originally expected has resulted in large increases in future premiums for existing policyholders. These large increases are the direct result of applying the loss ratio over the entire lifetime of the original group of policyholders. As a group, the number of policyholders shrinks every year due to lapse and death, but any premium deficits of the entire original group are allowed to be compensated by rate increases on the remaining policyholders. Thus, a small number of policyholders may shoulder premium rate increases many times over their original premiums. While it may be incredulous, this was the basis for how insurance companies and policyholders entered the insurance contractual agreement.

In retrospect, the use of unsubstantiated data to develop premiums and the rote application of the lifetime loss ratio formula have resulted in very undesirable consequences for insurance companies and policyholders alike. However, it is not particularly useful to dwell on the past. Although insurance companies and policyholders should fulfill their duties in accordance with the insurance contract, LTCI contractual provisions and the related rate regulations are not viable today. It is paramount for insurance companies and policyholders (with regulators acting on their behalf) to reach a new agreement on their respective shares of future financial responsibilities. The ultimate goal of the agreement is to establish a premium rate increase level at which policyholders are protected against onerous additional future increases and to gain greater assurance on future financial results for insurance companies.

The focus of this agreement should be on the currently in-force policyholders and not the entire original group of policyholders. A starting point for discourse could be the premiums that would have been developed if the current best estimates of risk factors were known at the onset. These are the premiums that the policyholders should have paid. The set of best estimates should include a margin for conservatism so that the probability of future premium increases is remote.

From the companies' perspective, they did not receive these premiums in the past to fund the higher level of future benefits. Thus, the current reserves, established based on assumptions that generated the original inadequate premiums, are unlikely sufficient to fund liabilities even with the premium increase. The starting point of negotiation for the insurance companies could be based on future financial result under the best estimate assumptions with a margin for conservatism. For example, the amount of premium increase can be determined to provide a specific ratio, positive or negative, of the present value of future distributable profits to the present value of future premiums. A ratio of zero would imply that no future gains or losses are expected. Different ratios may be set depending on the particular situation of the company, the current reserve level, or whether the block of business is open or closed.

If both parties are willing to make difficult but necessary choices, they can forge an agreement between the two starting points. The agreement should also include the following features:

1. Detailed disclosures by insurance companies of experience analysis and derivation of assumptions used in projecting future premiums, benefits and expenses;
2. Third-party independent review of the companies' financial projections and premium increase determination;
3. A guaranteed period during which premiums will not go up;
4. Full disclosure to policyholders of the amount of the ultimate premium increase, even though it may be spread over a number of years;
5. Expanded options for policyholders who desire to reduce their policy benefits or lapse the policies with extensive support on their decision-making; and
6. If premiums are proven to be excessive, refunds to existing policyholders who will pay for the premium increase or to their designated beneficiaries.

Early detection of premium inadequacy reduces the level of future necessary premium increase by spreading the burden to a larger group of policyholders rather than a smaller future group. It is therefore in the best interest of all policyholders to perform premium reviews on all policy forms for all companies. Reserve strengthening on many LTC blocks in the past is a strong omen that all stones should be turned over. After the premium increases, state insurance commissioners should require insurance companies to provide annual analysis of their experience, including the current margins of assumptions over actual experience. This practice would minimize

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unanticipated future discrepancies. Companies also should seek ways to limit their risk exposures by employing interest rate, inflation rate, and mortality hedging strategies. The costs associated with these activities should be included in the financial consideration.

PRODUCT INNOVATIONS

Market growth is predicated on a delicate balance of mutual interests between the insurance companies and the consumers. This balance was tilted when insurance companies' experience indicated that the risks inherent in LTCI were greater than they could manage. The lifetime coverage provision of the policies exposed companies to substantial variations from claim, investment, and persistency assumptions over a period of forty years or more. Moreover, the intended corrective mechanism for adverse experience has not worked because regulators have been reluctant to grant the necessary premium increases. To change these dynamic forces, the following non-traditional product designs may attract insurance companies to offer LTCI and consumers to purchase them.

- **Life and LTCI combination policies.** A logical step in LTCI product evolution is to reduce the number of risks for insurance companies. The recent life and LTCI combination policy design is such an attempt, where the death benefit is first paid to cover long-term care expenses before additional benefit is payable. This reduces the companies' claim exposure since a significant number of claims are of short duration (less than three years). Until recently, the vast majority of sales in life and LTCI combination has been single premium policies; there needs to be a lower cost, lifetime premium design in order to make these policies more affordable.

- **Universal LTCI.** In a similar fashion, an annuity with long-term care benefits design also can reduce insurance company exposure. This design is similar to universal life insurance, where periodic premium contributions are deposited into a policy fund, an annual cost of LTCI coverage is deducted from the fund, and interest is credited. The annual cost of insurance will increase with age. As with life and LTCI combination policies, the company assumes the morbidity and expense risks, while the policyholder retains the investment, lapse and mortality risks. This design would be quite attractive if the fund were embedded in a retirement saving account with the annual costs of insurance treated as tax-free and penalty-free withdrawals. However, there are several obstacles for such a product design. Since it provides a fund value, premiums would be higher than a comparable traditional LTCI policy. As interest credited to the policy is an important component in determining the premium contributions necessary to fund the policy, contributions would be relatively high in a low interest environment. Finally, state regulations currently permit increasing annual insurance costs only for attained ages under 65.

- **Policies with refund feature.** Another product variation would retain the structure of the traditional LTCI, but set initial premiums above a mandated minimum level. This could significantly reduce the likelihood of future premium increases. The minimum premium would be consistent for all policies with similar product features. Experience on this product would be reported annually to regulators, and premiums would be adjusted promptly if necessary. If premiums were found to be excessive, policyholders or their designated beneficiaries would receive refunds. This design could incorporate a high deductible (for example, a two-year elimination period) that would make the product affordable. This feature would make the LTCI policy a protection against a protracted period of long-term care rather than the initial period of care.

CONCLUSION

After years of uncertainty, the LTCI industry now has a greater understanding of the risks inherent in the product. The industry cannot be complacent, or it will continue to flounder and policyholders will continue to suffer. Moreover, there is no viable alternative to fund long-term care costs, and nearly all proposed public financing solutions involve the private market as complementary coverage. Thus, a vibrant private LTCI industry is vital to provide long-term care financing options for Americans. For the benefit of in-force policyholders and future customers, the LTCI industry needs innovative solutions. Now is the time to earnestly develop them. ■

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ENDNOTES

1 One exception is the life and long-term care combination insurance policies. However, the majority of these combination sales that provide LTCI benefits comparable to traditional LTCI have been the relatively expensive single premium policies. Accordingly they have not yet supplanted the traditional products.

2 According to the National Association of Insurance Commissioners' Long-Term Care Insurance Experience Report for 2016, approximately 500,000 claims were reported from 2006 to 2016.

3 That is, the amount that can be distributed to shareholders of a stock insurance company. Specifically, it is the after-tax statutory profit net of cost of targeted surplus and refund, if any, to policyholders.