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Challenges of Runoff LTC and Outsourcing to Mitigate Risk

By Jeff Anderson and Van Beach

There has been tremendous change in the long-term care (LTC) insurance market over the last 20 years. The torrent of new carriers entering the market in the late 1990s and early 2000s transformed into a rush for the exit. While at one point there were more than 100 companies issuing new business, we are now left with fewer than a dozen that offer stand-alone LTC policies. Given the long duration of LTC contracts, this mass exodus from the new business market has resulted in many runoff blocks of LTC policies. There has been some market consolidation, but there are also many orphaned blocks as companies have pivoted away from LTC but retained the risk on their existing policies. These blocks present a wide range of business risks beyond the inherent LTC insurance risk. If not addressed, the potential impact to the company can be severe and, as time passes, the range of options to mitigate these risks becomes more limited. Instead of waiting for a crisis moment, companies would be well served to assess the situation and make a conscious decision on how to proceed with the runoff of these blocks.

Third-party involvement can help reduce several risks involved in managing a closed block.

THE RISK OF ORPHANED LTC BUSINESS

Over time, many companies experience two phenomena with respect to blocks of runoff business. The first phenomenon is that product-specific knowledge becomes concentrated within a few individuals at the company. This occurs when a specific person or team is primarily focused on the runoff block. This can also occur when the company retains the subject matter experts (SMEs)

involved in original product development or management of the block when it was still open, if their knowledge is not shared and/or documented. This results in key person risk as the knowledge base consolidates due to either retirement or turnover. The second phenomenon is that product-specific knowledge is eventually lost. This occurs either as a result of knowledge concentration and turnover or as a consequence of orphaned blocks being bought and sold. This can lead to estimation risk if the business is not well understood and properly modeled.

Exacerbating the phenomena noted previously, many companies find it hard to retain and/or attract new actuaries to manage runoff blocks of business. Because of the long-tail nature of LTC products, it is likely that many of the current closed blocks will persist beyond the careers of most current actuaries. As existing SMEs retire, knowledge is often lost instead of transferred, or is transferred only temporarily and then lost due to further turnover. If companies are unable to retain or replace SMEs, this knowledge loss occurs more quickly.

Many of the assumptions used in the original pricing of LTC policies during the industry's sales peak were aggressive in hindsight. This has led to widespread rate increases and many companies have looked outward to consultants, reinsurers, and third-party administrators for assistance with these filings. This decision to seek assistance has often been driven by the realization that current staff lacks either the capacity or knowledge base, or sometimes both, to prepare and submit the rate filings. Fewer companies have sought outside assistance with financial reporting tasks, potentially because many valuation and reporting processes are well established. Those that do are often driven by a desire to remediate audit deficiencies, improve modeling due to business or industry changes, or supplement dwindling staff.

In many valuation and reporting processes, a large portion of the actuary's time is spent processing and moving data and results. This leaves less time for developing assumptions and analyzing results. Additionally, many valuation and assumption development processes have been in use for years. If not questioned, at least occasionally, this situation can result in actuaries and other staff following a certain process or using a certain method "because it's always been done that way." In light of recent industry news of large reserve increases and continued large rate increases, assumptions and processes should be reviewed with a fresh perspective and revisited regularly.

ASSESSING AND MITIGATING THE RISK

Third-party involvement can help reduce several risks involved in managing a closed block. Depending on the structure of the involvement, it is possible to reduce estimation risk, key person risk, and process risk. The level of third-party involvement can vary greatly and is usually driven by the types of risks a company



is trying to mitigate as well as the knowledge base and capacity of current staff. Involvement can vary from a high-level review of processes or assumptions to detailed experience analysis and assumption development to full outsourcing of actuarial tasks.

Estimation and process risk can each be mitigated through multiple types of arrangements. Often, when companies are comfortable with the status quo, the solution takes the form of high-level review by a third party. In situations when there are questions regarding the reasonableness of assumptions or the modeling approach, risk mitigation takes the form of a more detailed review or independent assumption and model development. In extreme scenarios with audit deficiencies or where material errors have been discovered, a more comprehensive assessment and remediation is required, often involving augmenting or replacing existing staff to reshape processes and controls. In some cases, the remediation required is so extensive that companies look to full outsourcing.

Key person risk can be effectively mitigated in multiple ways. Ideally, this is accomplished via thorough documentation of products, assumptions, and processes along with retention of existing staff. However, this is often not an option, given limited time and existing obligations of current staff. In these cases, companies may look to third parties to develop documentation or supplement existing staff to allow time for staff to assemble the documentation.

Unfortunately, some companies are unaware of their key person risk until it is too late and a key staff member has provided notice that they will be leaving. When this occurs, there is often a rush to do something as quickly as possible in order to take advantage of the key staff member's remaining time at the company. This is necessary to allow for as much knowledge transfer as possible. However, it may not be possible to sufficiently transfer enough knowledge to ensure a smooth transition. In this case, a third party may be needed to fill the

knowledge gap. In some cases the best answer is full outsourcing to address the impact of losing key individuals.

OUTSOURCING FOR CLOSED LTC BLOCKS

As noted previously, outsourcing—transferring the management responsibilities for an LTC block to a third party—is potentially a necessary move in order to address the adverse impact of various LTC business risks. However, for many companies, outsourcing certain processes is advisable even in the absence of an adverse situation. It is difficult with a small, orphaned block of LTC business to retain the talent, develop the process efficiencies, and achieve the scale needed for efficient and effective LTC actuarial operations.

Buoyed by the rise of cloud computing, there have been exciting developments in the capabilities of third-party outsourcing providers that reduce the previously noted risks and deliver scale and process efficiency. By aggregating the operations of these small blocks into a common platform, these third-party providers can bring greater levels of LTC expertise as well as advanced technology to address the requirements of the LTC business.

The typical infrastructure starts with a secure data exchange between the company and the outsourcing provider to move data that supports actuarial processes and also to return output, results, and analyses back to the company. Once in the cloud, highly-scalable data repositories capture and store the incoming data, often with automated validations and data cleansing algorithms. Valuation and modeling processes are built into controlled cloud environments that allow for end-to-end auditability while automating as much of the process as possible. Responsibility for assumption input and review can remain with the company or be transferred to the third party, and can be managed seamlessly through web-based portals where assumption governance protocols are enforced in a secure environment.

In conjunction with the scaling capabilities of cloud computing, the automation results in a dramatic reduction in time spent performing each valuation. Results are delivered through secure online portals where cutting-edge reporting tools are used to visualize and analyze the results. With nearly limitless capacity to capture and store data, the breadth and depth of reporting is similarly boundless, but effective reporting will put the most critical information at the fingertips of management. For LTC business, important business management metrics such as actual-to-expected results, variance attribution, and historical trend comparisons can all be automatically produced, along with other metrics requested by the company.

Checks and controls on both data and results are performed throughout the automated process. The top outsourcing providers are staffed with an in-house compliance officer and

will also provide a System and Organization Controls Type II Report (SOC 1 Type II Report) demonstrating successful execution of controls and security necessary for SOX compliance. This allows the company to rely on the results without needing to conduct its own audit of the provider.

In addition to the noted technological capabilities, top outsourcing providers can also contribute their expertise in order to support the company in many ways, ranging from developing assumptions to interpreting results. In situations where the company retains internal actuaries, the net result is that the company actuaries are freed from manual and inefficient operations and can focus on making business decisions to derive more value from the business. In situations where the company fully outsources all actuarial functions, the net result is a reduction in key person risk, an increase in available expertise and capacity, and a move toward a more variable expense structure. In both situations, the company is able to greatly reduce operational risk.

LTC IS RISKY BUSINESS BUT DOES NOT NEED TO INTRODUCE BUSINESS RISK

Today's LTC insurance landscape has many remnants from a rapidly expanding and then rapidly contracting market. Orphaned blocks of LTC business are scattered throughout the industry and pose business risk to the companies that retain the actuarial operations. There are many options for reducing key person risk, process risk, and estimation risk, among others—often facilitated by a third party for additional expertise or bandwidth. Third-party outsourcing providers have historically been a source of expertise for many companies. The recent technological advances of cloud computing have provided the scale, efficiency, and accessibility to enable these providers to also become an attractive option to address the business risks associated with runoff LTC blocks. The last 20 years have proven that LTC business is risky, but with options for outsourcing LTC actuarial operations and expertise, there is no reason that LTC needs to continue to be a business risk. ■



Jeff Anderson, FSA, MAAA, is an actuary at Milliman. He can be reached at jeff.anderson@milliman.com.



Van Beach, FSA, MAAA, is a principal at Milliman. He can be reached at van.beach@milliman.com.