

Improving the Profitability of In-Force, Long-Term-Care Insurance Policies

AS THE LONG-TERM-CARE INSURANCE (LTCI) MARKET continues to develop and mature, the ability to manage the profitability of closed blocks of policies has increased in importance. Companies close policy forms to new issues as new forms become available or as they exit the LTCI business altogether. This has resulted in large numbers of policies residing in closed blocks, estimated as 80 percent of active policies. According to the National Association of Insurance Commissioners' "Long-Term Care Insurance Experience Reports for 2003," LTCI policies in closed blocks had earned premium of approximately \$5.6 billion from 4.5 million policyholders in 2002.

A substantial number of these closed blocks aren't meeting their original profit objectives. Without attention, loss-making policies drain surplus from the company, possibly weakening the value of the coverage for policyholders in the loss-producing forms as well as for policyholders in other product types.

A company's initial efforts at improving profitability could involve expense reductions and claim adjudication process reviews, but there are a number of effective initiatives beyond that. These initiatives can benefit both the company and the policyholders as profit levels improve, surplus levels stabilize, and policyholders see options in handling their contracts.

How Did We Get Here?

Individual long-term care insurance is guaranteed renewable and priced assuming level premiums for life. It provides coverage for assistance with activities of daily living (such as bathing, dressing, and transferring patients from one bed to another) or disability due to cognitive impairment. Coverage can be provided for care in a nursing home, in an assisted living facility, or at home (depending on the severity of the disability).

Most of the policies today are issued at ages 50 to 70. Claim costs increase rapidly beyond attained age 75, and approximately three-quarters of the claims are paid at attained ages 81 through 95. Large, active life reserve balances (policy reserves) are built up during the early years of the policy.

Although the level of industry knowledge has been expanding rapidly in recent years, LTCI has been an experimental coverage and many of the actuarial pricing assumptions of the past have turned out to be inaccurate.

Generally, total persistency has been much better than expected, with voluntary lapses in the very low single digits and mortality lower than expected.

This is not good news for lapse-supported coverage like LTCI. Policy language in the past has been more generous than anticipated at time of pricing, and companies have com-

peted by adding benefits to each new generation of policies without fully adjusting premium rates. Rate-stability regulations implemented in the past few years may keep these problems from the past from being repeated in the future, but the legacy problem is large.

Problem Blocks of LTCI

For use in discussing initiatives, I've constructed two closed blocks of LTCI policies. For the first block, \$1 million in premium was issued each year, for 1996, 1997, and 1998. During 1998, the company closed this form, updated its underwriting standards, and re-priced a new policy form with higher persistency. For this second block, \$1 million in premium was issued each year for 1999, 2000, and 2001, and then the company exited the LTCI line of business.

Actual experience is emerging and indicates that for each block, ultimate lapse rates are 200 basis points lower than expected, mortality is at 90 percent of assumed, and claims are 10 percent above anticipated. These products were priced with a lifetime loss ratio of 60 percent, but the experience deviations noted above result in an anticipated lifetime loss ratio of 97.9 percent for these two blocks combined.

Exhibit I (page 54) compares the incurred loss ratios by calendar-year for these two blocks combined. Although the lifetime loss ratio of 97.9 percent will produce losses, the calendar-year loss ratios are in the single digits through 2002.

As Exhibit II shows, we had expected \$45.9 million in premium and \$27.5 million in claims over the life of these forms when priced. But now we're expecting to earn \$58.6 million in premium and pay \$57.3 million in claims, before any initiatives. Using the difference between premium and claims as a simple performance measure, this measure fell from \$18.4 million as priced to \$1.3 million.

The amount of expected claims has more than dou-

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EXHIBIT I

YEAR	EXPECTED (IN THOUSANDS)			ACTUAL (IN THOUSANDS)		
	PREMIUM	CLAIMS	LOSS RATIO	PREMIUM	CLAIMS	LOSS RATIO
1996	\$1,000	\$35	3.5%	\$1,000	\$41	4.1%
1997	1,862	82	4.4%	1,928	101	5.3%
1998	2,627	148	5.6%	2,806	188	6.7%
1999	3,322	210	6.3%	3,646	277	7.6%
2000	4,033	280	6.9%	4,478	378	8.4%
2001	4,746	362	7.6%	5,291	499	9.4%
2002	4,443	427	9.6%	5,084	604	11.9%
2003	4,191	499	11.9%	4,907	724	14.8%
2004	3,966	564	14.2%	4,750	844	17.8%
2005	3,758	656	17.4%	4,603	1,010	21.9%
2006	3,556	763	21.5%	4,451	1,215	27.3%
2007	3,359	911	27.1%	4,298	1,495	34.8%
2008	3,168	1,100	34.7%	4,143	1,861	44.9%
2009	2,984	1,335	44.7%	3,989	2,321	58.2%
2010	2,808	1,553	55.3%	3,834	2,771	72.3%
2011	2,636	1,733	65.8%	3,677	3,170	86.2%
2012	2,470	1,873	75.8%	3,518	3,514	99.9%
2013	2,310	1,977	85.6%	3,360	3,804	113.2%
2014	2,158	2,050	95.0%	3,204	4,044	126.2%
2015	2,013	2,071	102.9%	3,051	4,183	137.1%
Lifetime	\$45,900	\$27,500	60.0%	\$58,600	\$57,300	97.9%

EXHIBIT II

In millions

	PRESENT VALUE PREMIUM	PRESENT VALUE CLAIMS	PERFORMANCE MEASURE	LIFETIME LOSS RATIO
Expected	\$45.9	\$27.5	\$18.4	60.0%
Actual	58.6	57.3	1.3	97.9%
After 1st rate increase	61.8	54.3	7.5	87.9%
After 2nd increase & options	63.4	49.8	13.6	78.6%

EXHIBIT III

First Rate Increase by Component (in millions)

	PRESENT VALUE PREMIUM	PRESENT VALUE CLAIMS	PERFORMANCE MEASURE	LIFETIME LOSS RATIO
18% Premium increase	\$64.1	\$57.3	\$6.8	89.5%
6% Shock lapse	61.8	54.1	7.7	87.4%
Anti-selection	61.8	54.3	7.5	87.9%

bled, even though claims are only 10 percent higher than expected on a per-unit basis, emphasizing the importance of policy persistency to LTCI profitability. Also, because of the differences in persistency, the active life reserve balance will now peak at \$60.5 million in the year 2022, as compared to the expected peak at \$35.7 million in 2019 under-pricing assumptions.

Initiatives and Profit Impact

In terms of analyzing specific initiatives, we'll consider the effect of two premium rate increases along with policyholder op-

tions available at the time of the second rate increase. The rate increases not only produce the obvious higher premiums but they also result in additional lapses (positive financial impact) and anti-selection (negative financial impact).

In Exhibit II, we see that after the first 18 percent rate increase in 2005, the lifetime loss ratio has decreased to 87.9 percent and the performance measure has increased by \$6.2 million.

Exhibit III shows the financial impact of this rate increase assigning a value to each component: \$5.5 million due to the increase in premium, \$0.9 million due to

the additional lapses, and (\$0.2 million) due to anti-selection.

Additionally, there's the immediate financial-reporting impact of \$1.5 million of active life reserve released because of the additional lapses (or shock lapses). In this case, I'm using 6 percent for the shock lapses as an illustration.

The level of shock lapses is difficult to predict, and it may vary depending on the size of the rate increase, agent activity surrounding the rate increase, policy duration, company ratings, perceived company stability, and other factors. Policyholders who leave may be replacing coverage at similar rates and are able to pass underwriting at a new company or now choose to self-insure. These policyholders will tend to be healthier than the policyholders remaining, resulting in anti-selection.

With the second 18 percent rate increase in 2007, policyholders are offered two options to reduce their benefits: They keep their current policy and accept an 18 percent rate increase, or opt for coverage modifications to their current policy for a 20 percent reduction in benefits along with a net reduction in their premium of 5.6 percent.

For example, an option to increase the waiting period by 30 days, along with a \$10-per-day reduction in the daily benefits, could result in a 20 percent reduction. For illustration, if 50 percent of the policyholders elected the 20 percent reduction in benefits, then this is a 10 percent net reduction in risk and is equivalent to shock lapses of 10 percent.

Returning to Exhibit II, after this initiative, the lifetime loss ratio is decreased to 78.6 percent and the performance measure has increased by \$12.3 million from the baseline case. Also, there's the immediate financial reporting impact of \$3 million in active life reserves released, and the trend in future active life reserve balances is lowered.

In the example above, it's unlikely that 50 percent of the policyholders would elect a benefit reduction in these circumstances. To attempt to achieve the 10 percent net reduction in risk, the company may need to offer a number of options.

Companies sometimes offer a paid-up benefit as an option. This is a policy where the policy pool of money available to pay benefits is substantially reduced to an amount equal to the sum of past premium paid. The policy is paid up, and no further premiums are due.

One could imagine other offers, such as providing the policy reserve in cash in return for surrendering the policy. Or an offer to exchange to a new policy form that has revised language to address the problematic provisions of the old form, issued at original issue age rates without underwriting.

In a handful of states, including one with significant LTCI exposure, there's a regulation in place that allows for the non-renewal of LTCI policies in those cases where substantial losses have been consistent in the past and are projected to continue. The state is permitted to non-renew these policies under terms and conditions that are in the best interests of the policyholders.

It's challenging to craft a solution that non-renews a guaranteed renewable contract in a manner that's in the best interests of the policyholders. In cases where relief was provided, the solution was composed of variations on the policyholder options described above.

Although some might argue that it's always in policyholders' best interests to keep their full LTCI coverage in place regardless of rate increase activity or other factors, policyholders may be motivated to consider other options for a number of reasons.

In the time since purchase (which could be decades for some), their financial asset position may be better than expected or they may be much healthier than they anticipated, so they're willing to self-insure more of the LTC risk. Or they may be nearer to their children or have better access to a support system than they anticipated.

A decreased level of confidence in the company and the company's promise to pay benefits at some still very distant

point in the future could also be a motivator. Or because of the premium rate increases, the LTCI premium may be beyond what they're willing to pay.

Without explicit options, policyholders may believe that continuing their existing LTCI coverage is an "all or nothing" proposition. They may not be aware of the opportunity to make some modest changes, such as increasing their waiting period, that allow them to keep their premium reasonable with a modest increase in co-insurance. In many cases, it could be argued that an increased level of risk participation by the policyholder increases suitability.

The LTCI rate stability regulations, along with a more conservative approach by companies in the market, could mean that today's products are more likely to meet their profitability expectations as compared to earlier LTCI products. But there remain a large number of existing policies that need to be managed responsibly to assure that company stability is achieved and benefits get paid. ●



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