

Long Term Care Insurance: The Industry's Blackest Box, And a Policy That Can Hold You Hostage

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The thought of being unable to care for oneself and needing years of expensive assistance can certainly be financially, not to overlook, personally frightening. Theoretically, Long Term Care insurance (LTCI) can make a lot of sense. But, as is often said, the devil is in the details. More important than delving into contract details, however, is first having a solid, yet general understanding of the product – one that everyone can have. This knowledge will enable you to shop for LTCI with a special and insightful understanding of the importance of an LTCI insurer's: 1) expenses, 2) investment management activities, 3) ability to increase premiums on existing policyholders, and 4) assumptions about lapses – the percentage of consumers who drop or discontinue their coverage each year. This knowledge will enable you to avoid feeling like the very many very upset consumers who have recently experienced unexpected 20, 30, even 40% increases in their annual LTCI premiums.

An LTCI Primer

LTCI is actually a deferred, contingent annuity. It's deferred because one typically buys it years before it is likely to be needed. It's contingent upon actually needing the care – having a qualified claim. It's an annuity because it provides benefit payments to claimants over a previously-chosen potential duration, and it uses the annuity principal to maximize such potential benefits based on the varying longevities of claimants and claims.

Under an LTCI policy, an insured agrees to pay premiums of \$X/yr for a benefit of \$Y/day if the insured can't take care of him or herself; the duration of premium payments, the duration of the potential benefit payments, and assorted other factors (inflation adjustments, etc.) are all adjustable and set at time of purchase. One very important aspect of an LTCI policy, discussed in more detail below, is that the insured - unlike in his or her dealings with health insurance, life insurance, auto insurance, etc. or other financial relationships like mutual funds,

mortgages, deferred annuities, etc. - cannot change policies without incurring a significant financial loss; that is, the reserves the insurer has been accruing as a result of his policy are not transferable. (This aspect of **“being taken hostage by an LTCI policy”** is further discussed below).

Second, let’s recall that insurance is just a business based on probabilities and the time value of money. Insurance, contrary to some individuals’ views, is neither inherently good nor bad; it is fundamentally a way for individuals to voluntarily contract with an organization or a group of others to share risks. The general formula for an insurance product is that the actuarial value of the premiums equals the actuarial value of the benefits/claims plus the actuarial value of the insurer’s costs. (Actuarial values are just calculations that account for both the probability and the time value of money paid and received at different times.) An LTC insurer’s costs include general operating costs, claim management costs, sales costs, investment management costs, and profits (the cost of, or return on, the insurer’s capital); **in essence, an insurer’s “costs” are everything other than its claim payments to policyholders.** So now you ought to be able to build a long term care insurance policy! Well, maybe not. But, I hope, you’re at least getting some insight into how it is built.

A BIG QUESTION Given this understanding, **what percent of the actuarial value of premiums do you think an LTC insurer plans to pay out as benefits?** What would be an acceptable percentage for you to think about buying a policy? Please write down your answer before reading any further.

The Importance of an LTC Insurer’s Costs and Investment Operations

If two insurers, A & B, plan to provide the same benefits/claims, but if Insurer B has and builds its LTCI product on assumed lower costs, then everything else being equal – which is a big mouthful of assumptions – Insurer B’s policy would have a lower premium.

Part of that big mouthful includes an assumption about the discount rate or the guaranteed interest rate LTC insurers assume in building the product. For instance, if insurers C and D have the same expected streams of future annual

outlays for benefits and costs, but Insurer D assumes a lower discount or interest rate in building its products, then Insurer D would need to charge a larger premium. Or, to look at it another way, if Insurer D only expects to earn 3%/yr whereas all other insurers build their policies on the assumption of expecting to earn 4%, then Insurer D has to have larger premiums.

As you can readily sense from the above examples, one doesn't need to become an actuary to become a more informed LTCI shopper. In essence, every LTC insurer is trying to build-up a pool of reserves from which to pay the claims that might arise in 15, 20, or 25 years. Understanding the insurer's challenges not only spotlights the uncertainty and difficulties an insurer faces, and the importance of information about its costs and investment returns, but it also suggests two additional very important aspects of LTCI policies about which consumers need to be aware.

Two Important Aspects: Lapses and Potential Premium Increases

A very important factor that impacts whether or not the LTC insurer is building sufficient reserves is the number of policyholders who actually renew/continue their policies year after year. LTC insurers make assumptions about the number of policyholders who will drop or lapse their policies each year because policyholders who drop their policies actually contribute significantly to the insurer's reserves; that is, the lapsing policyholders in essence provide a subsidy to the renewing policyholders; in the industry vernacular, **this is known as lapse-supported pricing**. For example, if an LTC insurer had assumed in building/pricing its product that 5% of the policyholders would drop their policies each of the first six years, but only 2%/year actually do, then its reserves will be insufficient based on this greater percentage of policyholders continuing their coverage. (See endnote for more) ⁱ

Almost all LTCI policies allow the insurer if or whenever it realizes that it is not building, or not likely to build, sufficient reserves to seek regulatory approval to increase the premiums on **existing policies**. **Any significant unfavorable variation that occurs between an insurer's assumptions in building its LTCI policies and the actual performance it experiences can lead the LTC insurer to**

have to increase premiums on its existing policyholders. There are many causes for seeking such premium increases, some that might seem legitimate and fair to most reasonable people, but some other causes that might be debatable or not at all justified, especially if consumers had not been provided adequate information about such. For example, were the insurer's reserves low because it had 1) unrealistically initially expected/assumed higher returns on its invested reserves, or 2) suffered huge and completely unexpected higher claims costs because some worldwide virus infected almost every octogenarian causing all such policyholders to suddenly become claimants? Such different possible causes of inadequate reserves highlight a fundamental question: Who should bear the costs of such: the policyholders or the insurer (and indirectly, possibly, its stockholders)?

Non-Transferability: Policies That Can Financially Hold You Hostage

A final unique aspect of LTCI policies arises from their non-transferability; that is, once a policyholder has for years paid premiums, which the insurer has used to build reserves for his or her potential future claim, the policyholder cannot instruct the insurer to transfer the reserves built by his or her premiums to another insurer. This limitation is compounded by the time value of money and one's shorter longevity with each passing year. Clearly, this limitation emphasizes the importance of appropriate disclosure of LTCI policies. A consumer had better thoroughly understand an LTCI policy before getting locked-in, especially doubly so when the insurer has the option to increase premiums thereby not only holding a senior citizen financially hostage but also being able to **shoot him or her like a fish in a barrel** with increased premiums.

Food for Thought and Some Concluding Remarks

The above discussion makes clear several characteristics of LTCI policies that create unique challenges for consumers. For instance, how does a consumer distinguish between Insurer E's and F's policies? Assume Insurers E and F have essentially equivalent premiums, offer seemingly identical benefit descriptions, and yet have built their policies based on very different assumptions regarding benefits paid, operational costs, and investment earnings. Specifically, suppose Insurer E built its policies to pay significantly greater compensation to its sales

agents and/or possibly provide greater profits for its stockholders than Insurer F; say E's costs equal 41% of the actuarial value of the premiums received, whereas F's only consume 31%. In the current LTCI marketplace, however, information such as the percent of the actuarial value paid-out in benefits is not disclosed. So again how does one make an informed choice between Insurer E and F's policies? Or, given the limitations consumers face in their ability to change insurers, how does a consumer intelligently decide between insurers with different premiums when it is not known whether the difference in premiums is attributable to differences in investment assumptions, like Insurers C and D, or some other reason? In fact, since LTCI is as much an investment, an annuity, as it is an insurance policy - it would seem consumers would want and need to know how an LTC insurer performs and operates as an investment manager. No one, after all, agrees to send money endless to a mutual fund or any other business without understanding the dynamics and performance of such, especially if, again, additional payments could be requested if the product's performance is different from that of its undisclosed expectations.

With respect to possible premium increases in particular, what consumer ought to have to face a future premium increase, possibly made necessary by the insurer's failure to properly control sales and distribution costs, when no information at time of purchase about the magnitude of such costs had been provided? Specifically, how "friendly" is Big LTC Insurer when it tells you and your spouse after you've been paying for a few years that your annual premium must be increased by 20% because its reserves are insufficient? What if its reserves are low because it had paid out more than 150% of your annual premium in commissions? If you had known that, or alternatively, known the actuarial value of premium expected to be paid out in claims, would you have felt that your LTCI agent was being truly so caring and concerned about your financial well-being in so vigorously encouraging you to buy the particular policy he recommended?

In short, while LTCI is theoretically a very attractive product; the devil is in the details, and the details are not only undisclosed, they are significant material facts. Unfortunately, as shown in the separate pdf document, "**Answers to a Few LTCI Questions,**" when such details or material facts were requested

from several leading LTC insurers and agents, none provided sufficient answers. Consequently, due diligence reviews of LTCI policies cannot presently be performed.

Given such, it hardly seems unwarranted to say that state insurance commissioners have been, euphemistically speaking, totally out to lunch on LTCI regulation. It would be interesting to know what SEC Chair Mary Schapiro, FINRA Chairman Rick Ketchum, and other financial product and planning authorities think about long term care insurance as it is presently sold in the United States.

In summary, I think that LTCI, often privately referred to by its devoted agents as long term scare insurance, might really, with its widespread 20, 30, and 40% premium increases, heretofore have been called long term scam insurance. Consumers in general will only begin to receive significantly better value from LTCI once they with their friends in the media (the “Fourth Branch” of government, purportedly) demand solutions to the serious problems with the currently marketed LTCI policies. That such an inadequately disclosed product as to be the life insurance industry’s Blackest Box and a policy that can hold consumers hostage and shot like fish in a barrel has been so strongly endorsed by so many of America’s financial journalists is more than a little baffling; but that’s a story for another day.

Until then, LTCI Buyer: Beware! Ask Questions and Demand Value.

Your thoughts are always welcome on Breadwinners’ Blog. Please find the LTCI-related posts and tell us and the world your own views on LTCI.

PS Just to be clear, although I have railed against LTCI that does not mean: 1) there are no LTCI products I recommend, nor does it mean 2) that no one should buy LTCI. Clearly, there are some people who should buy it (and I trust they now can much better understand what they should buy). And indeed, there are various LTCI products I recommend in different circumstances. This article, though, is already long enough that I had best not now continue to “ramble on” about such specifics. **Certainly, any or all needing additional help with LTCI are invited to contact Breadwinners’ Insurance.**

PPS Regarding the question about the percentage of the actuarial value of LTCI premiums paid out in benefits, the answer – for this product that is fundamentally an annuity, a long-term investment with contingency boosters if one unluckily becomes “incapacitated” - is not 90%, nor 80%, nor even required in 49 out of the 50 states to be even 70%. The claims pay-out percentage is better for women than for men. But so as to not deprive you of the fun of learning it on your own, I encourage you to ask your agent, call your insurer, or, for real chuckles, write your insurance commissioner. If you then, don't like the answers you received, think about petitioning your Senators and House Representative because state regulation of insurance not only is anachronistic in our modern global economy and with financial institutions today larger and more powerful than foreign countries, it has been a disaster.

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The End

ⁱ Specifically, the insurer was expecting approximately 30% to have dropped out by the sixth or seventh year and have thereby provided a subsidy via the premiums they had paid to the other 70%, but instead the insurer had only 10% drop their policies. So the insurer is facing potentially aggregate claims of approximately 25-30% more than it originally expected, and yet its reserves, while larger, aren't commensurately larger. Having not experienced the same percentage of lapsing policyholders providing a subsidy for those persisting policyholder that it had assumed in designing the product, the insurer will need to raise premiums in order to be able to pay the likely greater aggregate claims because of having so many more policyholders remaining insured and being potential claimants. Lapse-supported pricing can be a two edged sword.