The Corvair of Financial Products: Long Term Care Insurance

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It would seem to go without saying that consumers need to really understand what LTCI is before shopping for an LTCI policy. While almost everyone intuitively recognizes that LTCI can provide, if one needs assistance with basic daily living activities, a daily or monthly payment to cover the possible costs of assistance, such a simplistic understanding is hardly sufficient. Unfortunately, the additional information typically provided by agents and others, such as the NAIC, AARP, and financial journalists, borders on pure sales blabber, financial stupidity, and/or emotional anecdotal wailings about the portentous dangers of being without any coverage.

To be able to make smart choices about anything, and to be able to presently make smart decisions about LTCI, it is critically important to have a good conceptual background or framework on the subject. To understand LTCI, one first has to recognize that this product is a contingent deferred annuity with some real additional complexity. Only after one understands LTCI conceptually, does it make sense to delve into various product alternatives and features.

LTCI is a contingent deferred annuity because to receive any benefit from a policy one has to suffer the contingency (need the care) that qualifies him or her for benefits. It is deferred because these policies often run 20, 30, or more years before one might have a claim; in fact, one cannot buy the coverage the day before it is likely to be needed. And, it is an annuity because benefits are distributed among the group of policyholders via the annuity principle, and also similar to conventional annuity payments, are paid from the time a claim starts for a pre-set duration, for example, possibly 3 years or as long as one lives.

Recognizing that LTCI is a contingent deferred annuity is, however, just the beginning of a proper conceptual understanding because it is an annuity with some very important additional complicating factors. These policies are: 1) unilaterally re-pricable, 2) inadequately disclosed, 3) non-transferable, 4) typically non-participating, and 5) prohibit a consumer from bargaining for a discount.

The typical LTCI policy, which requires that the policyholder pay an annual premium every year to keep the coverage in force, actually grants the insurer the right to raise the annual premium on all its policyholders (or more specifically, on all of its similarly-classified policyholders). One might have bought it, or entered into the contract, 2 or 3 years ago, and yet now the insurer can raise the annual price.

Such potential premium increases become required when an insurer realizes that it will not have adequate reserves to pay future claims, and reserves can be inadequate for many reasons. For instance, the insurer could have: 1) originally underestimated claims, 2) charged and thereby previously depleted policyholder reserves with excessive costs or profits, or 3) obtained inadequate investment returns. While an LTCI insurer needs regulatory approval before instituting premium increases, such procedures have hardly safeguarded policyholders from being blindsided and having to pay 20, 30, or 40% increases in annual premiums. There have been numerous articles about huge and consecutive premium increases; Joseph Belth's excellent monthly newsletter, *The Insurance Forum* (May 2012), reports on a CA resident whose monthly premium have nearly tripled over 18 years from $87 to $248. There have also been numerous articles about the many insurers that have left the LTCI market rather than continuing to raise the premiums on new policies, a business decision that can saddle existing policyholders with yet other and different serious risks.

Another reason reserves could be low is that the insurer overestimated the percentage of policies that would lapse. When an LTCI policy lapses, the reserves built from and supporting that policy can be used to pay for or subsidize another policy's possible claims. But when actual LTCI lapse rates have been significantly less than the lapse rates assumed/estimated in building the product (i.e., actual lapses were only 10% when they had been estimated to have been 50%, then the subsidies available from lapses are less than assumed), premium increases have been needed. Current LTCI disclosure practices, however, not only fail to provide consumers with adequate information about the likelihood of such post purchase re-pricing but in fact make consumers bear the burden of this undisclosed and unique risk, one arising from having purchased this purportedly risk-transferring product.

Not only can policyholders face unpredictable premium increases, but they cannot move or transfer their coverage from one insurer to another without sacrificing the value accrued from their prior premiums. This means that they can be shot like fish in a barrel. The inherent unfairness of such virtually avaricious and defective LTCI policies makes loan sharks envious. The policyholder Belth mentioned whose premiums nearly tripled in 18 year has also now had to file a lawsuit to try to obtain benefits. If you think all this doesn't sound very good, consider asking your state for its list of LTCI premium increase approvals and saying, "Nice Job" the next time you see your state's chief insurance regulator.

In addition, regulations currently prohibit consumers from bargaining with agents – this product's retailers - regarding the cost of an LTCI policy. Insurers may possibly raise premiums because their reserves are low quite possibly from having paid commissions which were too large and undisclosed. Yet regulations prohibit consumers from bargaining with agents to reduce LTCI's distribution costs, or to protect against such post-purchase re-pricing risks, and in fact these regulations also prevent agents from reducing or discounting the retail price. Consider offering mock praise to the regulatory prohibitions that make the life insurance industry the most anti-consumer, the most anachronistic industry in America. While you might be wondering: Where have America's consumer advocates been? That's also a wonderfully fascinating story, but it is a long and different story that must wait for another time.

In summary, recall, and be sure to always remember, that LTCI is fundamentally an annuity. Yet one that is re-price-able, non-transferable, and replete with the other problems mentioned above. But given that this product is a type of annuity – and annuities are a type of long term investments where the distribution of the policyholders' collective resources can be paid out for all policyholders' maximal benefit using the annuity principle – a mathematically-sound and very wise financial planning principle and tool – understanding the investment management practices and principles that underlie an LTCI policy are absolutely critical. In fact, without knowing the LTC insurer's investment management practices and principles, consumers don't know how they participate in the insurer's investment performance, they have been, and basically are, buying LTCI BLIND. If anyone disagrees and/or thinks it's good to buy investments or financial security blindly, then the new off-shore, hedge fund being operated from behind bars by Bernie Madoff could be a big success.

Interestingly, hedge funds which are restricted to sophisticated high net worth investors who can and routinely do pay for additional independent advice have better disclosure than LTCI policies. That's right. Products for the nation's financial elites have better disclosure than products state governments encourage ordinary consumers to buy, and which, in fact, a state government has even shared in agent commissions on sales to consumers. Not only have state insurance regulators never done their LTCI jobs, most have absolutely no shame about such failures; after all, no one with any power has ever held them accountable.

When sophisticated high net worth individuals invest in hedge funds, they are informed of the costs that the hedge fund managers will extract from the investment. The typical hedge fund annually charges 2% of assets under management and 20% of gains. On the other hand, virtually no LTCI consumers are informed that less than 70% of the value (actuarial value) of their payments will be paid out in benefits. In other words, LTCI extracts over 30% of the value of premiums paid into this product – a product that is suppose to provide financial security for America's ordinary individuals and families. While obviously the compared products are different and have different cost structures, there can be no valid objections to appropriate costs and compensation. But when there is inadequate product disclosure, the defenders of the status quo have a seemingly untenable task of trying to defend while on the slipperiest of slopes. As Vanguard's founder, Mr. Bogle, might be tempted to remark, there's something incredibly wrong with what is fundamentally an investment product – an annuity, admittedly with some extra legitimate costs upon payout – when the croupiers extract over 30% of the value of consumers' hard earned dollars.

But, don't get me wrong. Despite LTCI's profoundly inadequate disclosures, re-price-able, non-transferable, and anachronistic characteristics, LTCI can be a good product. However, if one doesn't understand what he or she is buying, and does not have a trustworthy adviser with genuine financial and LTCI expertise, then be prepared to be fleeced or disappointed. Because LTCI has been and will continue to provide excessive compensation to agents (compensation that informed consumers would find unacceptable), potentially unjustifiably large bonuses and profits for corporate executives and their companies, and yet remain a product upon which financial due diligence studies are practically impossible and unexpected premium increases and/or other consumer disappointments (i.e., claim disputes) are practically inevitable.

To be forewarned, is to be prepared, is to know how to avoid mistakes,
and avoiding big mistakes is a key to financial security.

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