

# Demystifying Cash Buyouts of Long-Term Care Insurance

February 18, 2021

**Morgan Lewis**



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# Introductions

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# Abstract

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*Cash buyouts can be good for LTCI policyholders and carriers, but for various reasons they have not been widely offered.*

*On this webinar we will explain the issues raised by cash buyouts, the primary impediments to more widespread use of cash buyouts, and our perspective on why those impediments – whether financial, philosophical, legal, regulatory or tax related – are either more imagined than real or can be effectively mitigated **when offered as an alternative to a rate increase.***

# Agenda

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Regulatory Perspectives

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Benefits and Impediments to Cash Buyouts

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Analysis of Legal Risks

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Analysis of Tax Issues

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Protecting Policyholders and Carriers

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Q&A and Parting Comments

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# Regulatory Perspectives

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**Rhonda Ahrens**

*Chief Actuary, Nebraska Department of Insurance*

**Paul Lombardo**

*Director, Life & Health Division, Connecticut Insurance Department*



# Cash buyouts for LTCI: Lots of interest, but little consensus...

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**Various NAIC subgroups are considering the issue**

- Reduced Benefit Options (“RBOs”) Subgroup
- LTC Pricing Subgroup

**There are many differing viewpoints on the topic**

**The handful of articles and presentations on the topic raise many issues but not many solutions**

- AHIP and ACLI recently outlined *many* issues that need to be considered, including anti-selection, tax, legal, fairness<sup>1</sup>
- Milliman outlined various advantages and disadvantages from different perspectives<sup>2</sup>

**There is no clear roadmap**

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<sup>1</sup> *Considerations Regarding Long-Term Care Buy-Out Options*, by Jan Graeber and Ray Nelson. [https://content.naic.org/cmte\\_b\\_ltc\\_price\\_sg.htm](https://content.naic.org/cmte_b_ltc_price_sg.htm)

<sup>2</sup> *Advantages, Disadvantages and Considerations for LTC Policy Buyouts*, Long-Term Care News, February 2020, by Jeff Anderson and Mike Bergerson



# Benefits and Impediments to Cash Buyouts

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**Douglas Greer**

*Senior Director, Alvarez & Marsal*



# Cash buyouts can be a good alternative for policyholders



**Eliminate uncertainty over future premiums and benefits**  
(especially if there is a solvency issue)

- Policyholders are fatigued by multiple rounds of rate increases, and fearful of more to come
- They may need to reduce benefits in future to maintain affordability



**Provide meaningful value to policyholders who no longer desire coverage**

- Individual circumstances can change considerably over the years a policyholder typically holds a LTCI policy
- The only existing option for policyholders who no longer want their insurance is reduced paid-up coverage (also known as a nonforfeiture option, or “NFO”)



**Provide a level of financial flexibility afforded by other long-term and estate planning products**

- Whole life, universal life, variable life, indexed annuities and deferred annuities all include a cash out option
- Term life policyholders can cash out in the secondary market in certain circumstances



**Decrease chance that remaining policyholders will one day be subject to guaranty association limits**

- The buyout can reduce the risk of insolvency for carriers (depending on how the offer is priced)
- Policyholders of more solvent carriers can be more confident they'll receive the benefits they're paying for

# Cash buyouts can be good for LTCI carriers

**1 PERMANENTLY COMMUTE THE RISK OF POLICIES THAT ACCEPT THE BUYOUT**

**2 REDUCE CARRIERS' "PROBABLE MAXIMUM LOSS"**

**LTCI experience seems bound to get worse over time**

Business that seems adequately priced / profitable today may one day prove to be unprofitable

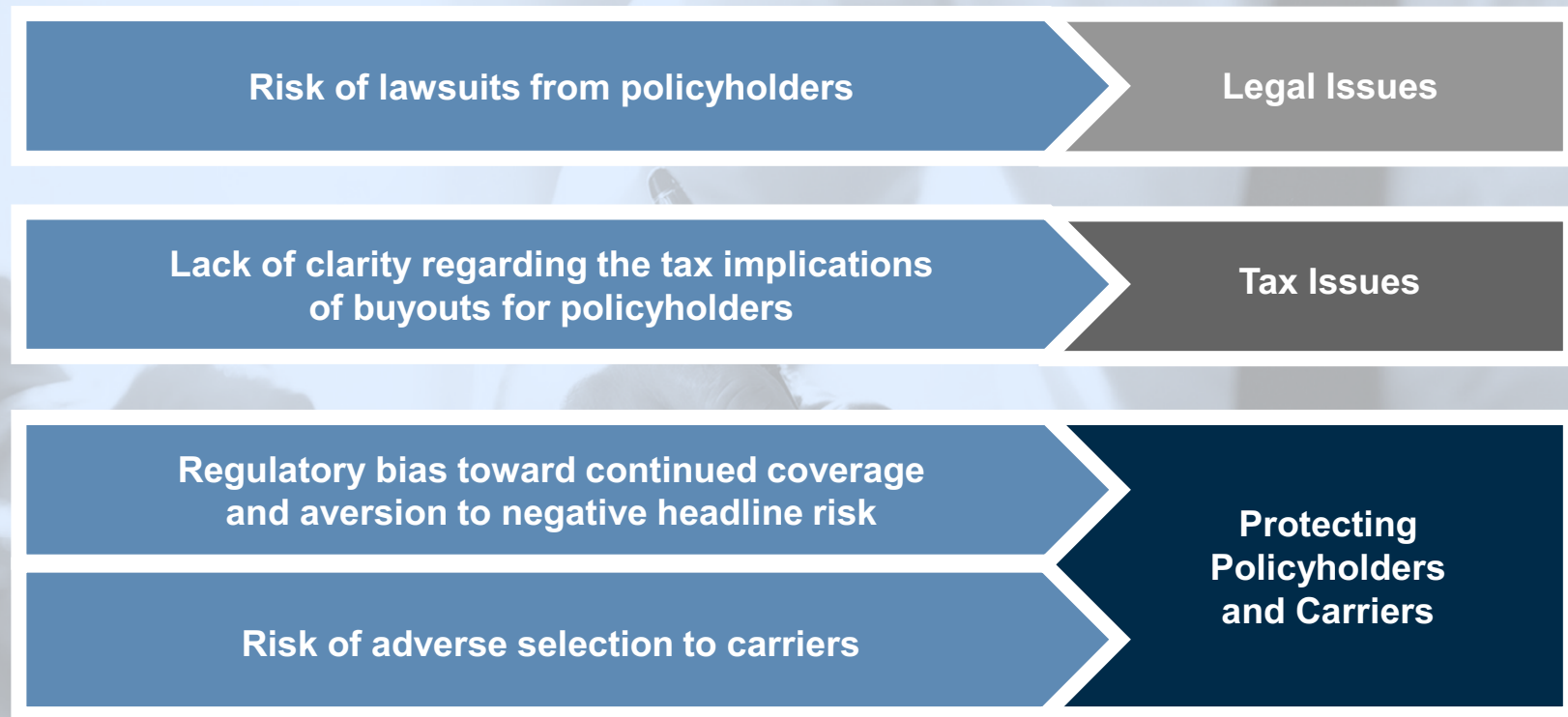
The lag between when pricing inadequacies become apparent and when (and if) appropriate levels of rate increase are granted make it very difficult to maintain target profit margins

**Shrinking the block reduces the potential scale of further adverse development**

**3 INCREASE STATUTORY SURPLUS (DEPENDING ON SIZE OF OFFER AND HOW IT IS MADE)**

# For various reasons, cash buyouts have not been widely offered by LTCL carriers

## Marketplace Perceptions:





# Analysis of Legal Risks

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**Harold Horwich**

*Partner, Morgan Lewis & Bockius*

# Managing Legal Risk: Regulatory Approval & Disclosure

## CONTRACT LAW

Policies are contracts and rules governing modification of contracts apply.

- Consideration
- Consent
- Lawful object
- Capacity

## INSURANCE LAW

- Buy-outs must be approved by regulators in conjunction with rate increases.
- Regulators have broad authority over what to approve.
- Application of the “filed rate doctrine.”

## MISREPRESENTATION

Common law misrepresentation and Unfair Trade or Insurance practices

- Attacks on rate increases based on failure to disclose at the time of policy issuance have not been successful.
- Skochin v. Genworth – implications for disclosure and limitations on the filed rate doctrine.



# Analysis of Tax Issues

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**Harold Horwich**

*Partner, Morgan Lewis & Bockius*



# Analysis of Tax and Tax Reporting Issues

## IRS has been stingy with guidance on long term care insurance generally.

- **TQ:** There is statutory guidance for what features are needed to constitute a “tax-qualified” (“TQ”) policy (elimination period, no cash surrender value, must offer inflation protection and NFO, limited triggers etc.) If met, claim payments are not taxable, and premium payments can be deductible as medical expenses assuming that thresholds are met.
- **NTQ:** No guidance on the taxability of claim payments under non-tax qualified (“NTQ”) policies or the deductibility of premiums.
- **Dispositions:** No specific guidance on policy dispositions.

## Cash buyouts are analogous to disposition of an asset.

- Basic rule is that income is taxable. Income is proceeds minus basis.
- **TQ:** basis is likely to be the premiums paid reduced by amount of tax deductions that could have been taken (whether they were taken or not).
- **NTQ:** basis is premiums minus benefits received.

Offering cash buy-out should not alter the status of TQ policies if done once. Offering it with every rate increase could jeopardize status if increases are frequent.



# Protecting Policyholders and Carriers

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**Douglas Greer**

*Senior Director, Alvarez & Marsal*

# Protecting Policyholders: Should Buyouts Be Offered, and If So, How Priced?

**SHOULD EVERY POLICYHOLDER SUBJECT TO THE RATE INCREASE GET A BUYOUT OFFER?**

**WHAT LEVEL OF REGULATORY PROTECTION FOR POLICYHOLDERS IS APPROPRIATE?**

(Analogous situations – structured settlement sales vs. life settlements)

**IS THE BIAS TOWARD KEEPING COVERAGE IN PLACE JUSTIFIED?**

- Most policyholders are capable of making rational decisions
- They are permitted to make decisions for themselves in many analogous situations
- If necessary, operational safeguards can be put in place to protect policyholders who are not capable of making rational decisions (for example, cognitive screening)

**DOES THE BUYOUT PRICE NEED TO BE ACTUARIALLY EQUIVALENT?**

- Actuarially equivalent to what?
- Other alternatives are not actuarially equivalent, and cannot be made so (NFO)
- Is it better to offer policyholders additional choice beyond non-forfeiture, rate increase, or benefit reduction?

## Question For The Audience

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**For how far into the future can an average 80-year old accurately predict their need for long term care services?**

**A. <1 YEAR**

**C. 3-5 YEARS**

**B. 1-3 YEARS**

**D. >5 YEARS**

# Protecting Carriers: Adverse-Selection Risk

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## **Often cited as a financial concern for carriers & remaining policyholders:**

If the policyholders who accept buyouts would not have gone on claim, then their departure worsens the financial condition of the insurer

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Every policyholder option comes with some level of adverse selection risk

But the adverse selection effect is likely to be small, as few individuals have clarity about their health beyond 18 months

This risk can be offset by offering a conservative buyout price





## Q&A and Parting Comments




# Questions, Answers & Parting Comments

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- 1 LTCI buyouts are still a new concept, without many precedents
- 2 Companies and regulators are still feeling their way
- 3 But there are clear guideposts along the way, for those who know where to look for them
- 4 Safe passage does exist for those who want to take the route

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