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by Bruce A. Stahl

everal long-time participants in the long-term care insurance (LTCI) market recently announced they would no longer be selling the product. One reason? The ongoing low interest rate environment. Clearly, these insurers sought to relieve the pain from what they saw as an insoluble

what was anticipated when the policy was priced. This is particularly true when policies are designed with an increasing maximum benefit feature.

Many LTC insurers offer an automatic annual increasing benefit maximum feature with their expense reimbursement policies, to compensate for provider cost inflation. When policies have this feature, insurers are less likely to pay out the maximum.

LTCI policies with a 5 percent compound increasing maximum feature can be quite sensitive to cost of care inflation. If the cost of an insuredôs care has a constant annual inflation rate of 5 percent, the expected ratio for LTC insurers of actual costs to maximum benefits permitted will remain essentially constant.

If the annual rate of economic inflation is less than 5 percent, however, the ratio of actual expenses to the maximum reimbursement will shrink, extending the time benefits may be payable. Extending the time is generally less expensive for the insurer, because fewer claimants will reach maximum payouts.

On the other hand, if the annual inflation rate is greater than 5 percent, the ratio of actual expenses to the maximum reimbursement will increase, and insurers could risk paying out 100 percent of the policy benefits.

This sensitivity to inflation is important to any projections of future liabilities, whether for testing reserve adequacy, deferred acquisition cost (DAC) recoverability, or identifying a need for rate increases. This is particularly true if annual inflation is tied to the assumed interest rate when sensitivity of interest rates is being tested.

INTEREST RATES AND INFLATION RATES

Inflation rates and interest rates are interrelated in two basic ways. Lenders, or suppliers of money, charge at least as much for the use of their money as the expected cost of waiting either to consume products or to invest in other assets (inflation). In this view, interest rates are determined by inflation rates.

On the other hand, the Federal Reserve may try to manage inflation through monetary policies intended to manage interest rates. Perhaps oversimplifying, a lower cost of money (or interest rate) is expected to increase borrowing demand for the purchase of goods and services, which in turn tends to increase the cost of those goods and services, thereby generating inflation. In this view, inflation follows earlier interest rates.

Both of these scenarios suggest that the cost of money and the rate of inflation undergo some continuous balancing of supply and demand as well as cause and effect, and are correlated over time.

The products and services for which LTCI pays have their own rates of inflation, which must be considered by insurers when pricing LTCI policies. The inflation rate of nursing home care costs has been tracked by the Bureau of Labor Statistics (*p//vkgj#b*) for 12 years, and has turned out to have a positive correlation coefficient of close to 50 percent with Moodyôs Aaa Seasoned Corporate Bond yield index (*p//w gjsH15/tdm*).

Over the past 12 years, Aaa corporate bond yields tracked by the Moodyôs index averaged close to 5.8 percent, while nursing home cost inflation averaged

INVESTING LTCI ASSETS

LTCI assets are often invested to meet cash flow expectations where the projected liabilities are kept constant. This may work for predefined cash benefits, but not for expense reimbursement policies ð and especially not for expense reimbursement policies with an inflating maximum feature.

The investment strategy would likely be much different if the projected benefits on expense reimbursement policies were to change along with projected yield assumptions. In fact, a strategy based upon multiple projected inflation-adjusted cash flows could suggest investing for shorter durations than the typical investment strategy for LTC insurance.

Often, the investment strategy for a single set of projected cash flows is to keep the assets invested as long as possible in order to match the assets with a very long average liability duration. This is probably appropriate for predefined cash benefits. But even with such cash benefits, strategies and incentives may be out of sync. Some investment managers may have incentives to produce high short-term returns and take capital gains at a point in time when a manager of LTCI portfolio assets might prefer to see the investments held longer.

Some asset managers have looked at managing interest rate risk by using certain hedging instruments and strategies.

MANAGING LTCI ASSETS

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