



SEPTEMBER 16, 2019

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## Long-Term Care: Investment Opportunities in a Changing Regulatory Environment

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Insurers, state insurance regulators, actuaries and potential investors in the long-term care insurance industry have been increasingly concerned with potential shortfalls in the assets necessary to support long-term obligations to policyholders, i.e., reserve deficiencies. Last month, Fitch Ratings published in its annual report on long-term care insurers and noted that the reserves established by many long-term care insurers were most likely inadequate. There is a widespread perception among observers of the long-term care insurance industry that this under-reserving is systemic, affecting both large and small insurers in this market. The problem is exacerbated by the difficulty in obtaining regulatory approval for rate increases of an order of magnitude necessary to eliminate the shortfall.

As a result of the ongoing issues facing the industry, certain insurers have considered reducing or eliminating their long-term care exposure by offloading their long-term care insurance business to financial buyers and/or reinsurers. Recently, there has been increased M&A activity in the long-term care insurance space, such as CNO Financial Group, Inc.'s 2018 long-term care reinsurance transaction with Wilton Reassurance Company and China Oceanwide Holdings Group Co., Ltd.'s acquisition of Genworth Financial, Inc., which has not yet closed. Despite the risk associated with the long-term care business, potential investors, including private equity funds, may be interested in an acquisition due to attractive pricing, i.e., a negative purchase price or ceding commission paid to the buyer or reinsurer, all or a portion of which may be contributed to an acquired long-term care insurer. For reinsurers and/or private equity funds, the opportunity to manage reserves strengthened by negative ceding commissions and to generate cost-savings through a consolidation strategy, coupled with the increased likelihood of state regulators approving rate increases to stave off potential insolvencies, can be attractive. On the other hand, middle-market long-term care insurers may face difficulties in selling or reinsuring their long-term care business given the requirements imposed by potential buyers, in particular the large



negative ceding commissions. These insurance companies may struggle to raise capital or increase their reserves for their long-term care business. Nonetheless, there seems to be ample opportunity for private equity funds and reinsurers to collaborate in potential acquisition opportunities in this space.

### RECENT DEVELOPMENTS OF THE NAIC LONG-TERM CARE INSURANCE TASK FORCE

The issues currently facing the long-term care industry have not gone unnoticed by state insurance regulators. During the 2019 National Association of Insurance Commissioners (NAIC) Summer National Meeting, West Virginia Insurance Commissioner Scott White, the Chairman of the NAIC Long-Term Care Insurance Task Force (the “LTC Task Force”), stated that the NAIC would make the long-term care insurance industry its top priority for 2019. White identified a range of problems, including reduction in the size of the long-term care market, reserve inadequacies, threat of long-term care provider insolvencies (the Penn Treaty Network America Insurance Company insolvency being a well-known example), significant rate increase requests by insurers and the resultant impact on consumers, and inconsistent approaches taken by the different state insurance regulators with respect to the rate review process.

The rate review process refers to the process in which a state insurance regulator evaluates and approves/disapproves of a premium rate change proposed by an insurance company with respect to an insurance product issued by such insurer. As part of the process, a state insurance regulator will make a determination regarding whether the change is justified based on various actuarial and non-actuarial factors (e.g., likelihood of insurer solvency, financial impact on consumers, etc.). In states with large senior populations or elected insurance commissioners, rate increases may be a significant political issue.

Although state insurance regulators generally acknowledge that the issues raised by Commissioner White exist in the industry, they have not been able to agree on the best approach to resolve them. The Commissioner’s Task Force has been charged with two major goals:

1. to develop a consistent national approach for reviewing long-term care insurance rates that result in actuarially appropriate increases being granted by the states in a timely manner; and
2. to focus on ensuring that consumers are provided with meaningful options to reduce their benefits in situations where the premiums are no longer affordable.

Elimination of the regulatory uncertainty around rate increases could make long-term care insurance companies and blocks of long-term care insurance business more attractive acquisition targets, as financial buyers and reinsurers make calculated assumptions about the obtainability of rate increases.

### SIX WORKSTREAMS OF THE LTC TASK FORCE

The LTC Task Force has developed six different workstreams for the NAIC, consisting of the following:

1. The first workstream would be a multistate rate review. The LTC Task Force will review the variety of practices currently employed, and the actuarial methodologies utilized, by the different state regulators in their long-term care rate review process. Review of these different practices would help the LTC Task Force develop a consistent national process in reviewing long-term care rates which could ultimately be achieved through two potential approaches: expanding the scope of the Interstate Insurance Product Regulation Commission (Compact) or developing a multistate examination model.
2. The second workstream would be focused on restructuring techniques, potential alternatives for protecting policyholders from guaranty fund caps, and the impact that may result from the inconsistent approaches taken by different state regulators with respect to long-term care rate decisions. (Guaranty funds are funded by contributions from the insurers writing a particular line of business in the market to protect policyholders in the event an insurer that



issued policies in such line of business becomes insolvent. When an insurer becomes insolvent, the guaranty fund steps in to pay claims in lieu of the original insurer.)

3. The third workstream would be focused on the reduced benefit options and consumer notices sent by insurers offering reduced benefit options in lieu of rate increases.
4. The fourth workstream would be focused on valuation of reserves by long-term care insurers and how to properly balance rate increase decisions and assumptions and reserving assumptions.
5. The fifth workstream would examine non-actuarial factors that state regulators consider when approving rate increases, gain a better understanding of why non-actuarial factors are considered during the rate review process, and possibly develop a uniform set of non-actuarial factors.
6. The last workstream would be focused on whether additional data is needed by the LTC Task Force and would review the financial impact of the varying state practices.

The LTC Task Force anticipates on submitting a proposal regarding the issues being addressed by the different workstreams by the 2020 NAIC Fall National Meeting. Closely monitoring these developments will inform decisions about whether to pursue transactions in the long-term care insurance sector.

#### FURTHER COMMENTARY AT THE NAIC REGARDING LONG-TERM CARE INSURANCE

A representative from the Center of Economic Justice (CEJ), a non-profit organization, noted at the Summer National Meeting that the fundamental question facing regulators was how to allocate increased costs between insurers and policyholders. The representative believed that the insurers and their shareholders should be responsible for most of these costs for myriad reasons, including that the recent demand for rate increases was caused by mispricing by the insurers and by the particular insurers' decisions to reduce the availability of such insurance to new policyholders, thereby reducing premiums that would have been generated by writing new business. Further, in the view of the CEJ when an investor previously purchased shares in an insurance company, such shareholders understood that their investments were not risk-free. They benefitted from the insurers' prior earnings (e.g., dividends) with respect to the sale of long-term care insurance and thus should be responsible for any losses that may result. The CEJ's concerns apply mostly to existing shareholders of long-term care insurers, not new investors who have required reserve strengthening as part of the investment transaction and priced the obtainability of premium rate increases into their investment decisions.

The CEJ representative also faulted insurance companies, noting that some insurers may not be filing for regulatory approval of alternative approaches – reduced benefit options or buyout of the policy – with state regulators. The representative argued that any rate increase approval should include the filing and approval for reduced benefit options because consumers are unable to determine whether a rate increase and benefit reduction are economically equivalent. The CEJ's argument was that state insurance regulators should develop information concerning the different options to assist consumers make a decision, e.g., weighing average costs of services today and in the future.

Lastly, the representative expressed concern that insurers may take advantage of the insurance business transfer statutes that have been recently passed by a number of state legislatures (e.g., Oklahoma and Illinois). Insurance business transfer statutes generally permit an insurer to transfer and novate all or a part of its business to a new insurer without obtaining policyholder consent. Insurers could use these statutes to spin off their long-term care business into a separate company. Tyler Laughlin, the First Deputy Commissioner & Chief of Staff of the Oklahoma Insurance Department, assured the LTC Task Force that Oklahoma regulators would not allow any effort by an insurer to utilize Oklahoma's insurance business transfer statute for long-term care insurance.



Highlighting the public policy concerns involved in LTC regulation, California Health Advocates (CHA), a California-based Medicare advocacy and education non-profit, gave a presentation at the last NAIC meeting including statistics on purchasers of long-term care insurance (e.g., age, income, marital status, assets, education and employment status), profile of the average caregiver, where benefits are paid (i.e., for home care, assisted living or nursing home care), and the duration of long-term care benefits. The CHA stated that it counsels policyholders on reduced benefit options and generally advises policyholders not to reduce their daily benefits below a minimum amount and to consider the possibility of subsequent rate increases and/or benefit reductions when electing an option. Increasingly, observers of the long-term care insurance industry are resigned to the possibility of rate increases.

A representative from the American Council of Life Insurers (ACLI), a Washington, D.C.-based lobbying and trade group, also shared ACLI's perspectives on the industry. First, the ACLI noted that the discrepancy in rate review practices employed by the different state regulators has resulted in policyholders from different states paying significantly different premiums for the same coverage. The ACLI believes that this issue could be resolved through a consistent national approach that:

1. establishes a single point of review;
2. uses a uniform set of information to be included in the rate filing; and
3. uses a uniform methodology that produces an actuarially justified rate increase and reflects adjustments due to past differences in rate approvals between states.

In the view of the ACLI, a consistent national approach would allow insurers to offer the same set of options to policyholders in all states along with consistent messaging, e.g., consumer notices, with respect to both existing and new blocks of long-term care business.

#### PROSPECTIVE PRESENT VALUE (PPV) APPROACH TO RATE DETERMINATIONS

The ACLI also expressed its support for the prospective present value (PPV) approach to rate determinations. The PPV approach:

1. does not allow recoupment for prior losses, but operates on a forward-looking basis;
2. considers a state's prior rate actions and thus eliminating any difference in the amount of premium paid by policyholders in different states for the same coverage; and
3. addresses small remaining blocks and is completely actuarial in application; there are no subjective non-actuarial factors.

The PPV approach would allow insurers and state insurance regulators to determine an actuarially justified rate increase and would hopefully eliminate the need for further rate increases in the future. Since under the PPV approach rate increases would not allow recoupment for prior losses, under this regime investors should (i) not factor rate increases into their valuation of long-term care business and (ii) not accept less reserve strengthening for an acquired business based on the expectation of offsetting future rate increases.

Also, the ACLI noted that, based on the experience of its members, consumers tend to retain their existing long-term care policy when faced with a rate increase. Historically, only 2% to 3% of policyholders will terminate coverage and less than 8% of policyholders elected to reduce their benefits. This suggests that investors should not expect high lapsation rates to generate significant potential value.



## CONCLUSION

Investment in the long-term care sector by private equity funds and reinsurers is beneficial from a public policy standpoint. Private equity funds and reinsurers are sophisticated in their valuation of potential targets—either long-term care insurance companies or blocks of long-term care business—and would have the ability to price deals to ensure that their consideration in potential transactions includes sufficient negative purchase price or ceding commission to address regulators' concerns regarding reserve levels.

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