



Why Systemic Risk Considerations Affect the Market for Long-Term Care Insurance

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It is widely recognized that the population is aging and healthcare costs are rising, trends that signal significant strain on entitlement programs in the future. The costs associated with long-term care (LTC) have been of particular concern; the Government Accounting Office estimated that LTC expenditures in the U.S. represented nearly 12 percent of all healthcare expenditures and noted that the majority of LTC expenditures are being paid for by

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public programs (GAO 2002). These concerns were echoed in HHS Secretary Sebelius' October 14, 2011 letter to Congress about the Community Living Assistance Services and Supports (CLASS) Act that noted, "But despite our best analytical efforts, I do not see a viable path forward for CLASS implementation at this time," in reference to the requirement that any plan be "actuarially sound and financially solvent for at least 75 years."¹

Private sector solutions are proving equally elusive. Numerous researchers have documented the low demand for private long-term care insurance (LTCI) and considered a variety of market frictions that might provide an explanation (see Brown and Finkelstein 2009 for an overview). In addition, while the private LTCI market suffers from many of the usual

problems of insurance (e.g., moral hazard, adverse selection, low risk perception) there is a potential threat to this market from a wholly different source: financial regulation aimed at mitigating systemic risk.

Systemic risk considerations in the form of new capital requirements and financial regulation could discourage participation in the long-term care insurance (LTCI) market by some of the largest insurance providers, as evidenced by MetLife's decision to exit the business despite demographic projections suggesting growing demand for such products. In this note, I highlight how MetLife's exit relates to the debate on systemically-important institutions—an aspect that to the best of my knowledge has been largely overlooked.

WHY BANK HOLDING COMPANY (BHC) REGULATIONS AFFECT INSURERS

While known for its insurance business, an often overlooked fact is that MetLife is also the 7th largest Bank Holding Company (BHC), with total consolidated assets of more than \$770bn as of June 30, 2011.² An implication of this fact is that the Federal Reserve is MetLife's primary regulator, as it is for all Bank Holding Companies. In the aftermath of the near-bankruptcy of insurance giant American International Group, Inc. (AIG), many other insurance companies (e.g., Hartford Financial, Lincoln National) sought BHC status. A key benefit of BHC designation was that it afforded firms access both to the Federal Reserve's lending facilities and the U.S. Treasury's Troubled Asset Relief Program (TARP). A key cost that BHC status brought was the obligation to meet capital adequacy requirements that had been designed primarily around banks', not insurers', balance sheets. At the same time the BHC landscape was changing, regulators around the globe were also discussing important changes to these capital requirements, with particular attention focused on those BHCs that were deemed to be "systemically important."

HOW CAPITAL REGULATIONS COULD AFFECT THE LTCI BUSINESS

The past two decades witnessed substantial innovation in the banking sector and with it, a recognition that existing capital regulations did not adequately capture the varying degrees of risk that banks' exposures now carried. The result was a new set of principles, commonly known as Basel II, introduced by the Basel Committee on Banking Supervision and adopted by countries around the globe, including passage in the form of new regulation in the U.S. Basel II was intended to be more risk-sensitive than its precursor (known as Basel I) and also to match more closely the measurements banks employed for the purposes of their own internal risk management. The exact formulation of Basel II differed across countries due to the need for the regulations to mesh with each country's existing legal, tax, and accounting regulatory frameworks. For example, in the US, only the largest BHCs were required to adhere to Basel II, although other BHCs would be allowed to "opt-in."

Before Basel II could be fully-implemented in the U.S., the recent global financial crisis generated renewed attention on the

importance of stringent capital regulations as a way of safeguarding financial institutions, in recognition of the important role such institutions have in the global economy. Regulators across the globe began to work on further modifications, resulting in so-called Basel III. At the center of the discussion was how firms use derivatives and a call for substantial increases in the capital requirements associated with derivatives exposures that remained on-balance-sheet for long periods of time.

Insurance companies make extensive use of derivatives contracts—exactly the asset class that is the core focus of the proposed more-stringent capital requirements. Yet because of the nature of their business, insurance companies, unlike many other BHCs, maintain derivatives exposures almost entirely for hedging purposes, for example to protect against the uncertainty embedded in long-dated liabilities such as LTCI. Thus, insurance companies' derivatives are primarily on-balance-sheet exposures and often remain on-balance-sheet for long periods of time. As a result, despite their role in mitigating risk, these derivatives also could subject insurance companies to significantly increased capital requirements.

That new regulatory capital requirements would impact the insurance industry was confirmed on November 4, 2010, exactly one week before the LTCI exit announcement, when MetLife filed its quarterly 10-Q report with the SEC and stated (page 127): “In addition, the oversight body of the Basel Committee on Banking Supervision recently announced increased capital and liquidity requirements (commonly referred to as “Basel III”) for bank holding companies, such as MetLife, Inc. Assuming these requirements are endorsed and adopted by the United States, they are to be phased in beginning January 1, 2013. It is possible that even more stringent capital and liquidity requirements could be imposed under Dodd-Frank.”

THE DIFFICULTY OF HEDGING LONG-DATED LIABILITIES THAT ARE OUTPACING INFLATION

Even without increased capital requirements, the insurance industry faces significant challenges in providing LTCI, including tremendous uncertainty regarding claims and escalating costs far into the future. Because medical costs have outpaced both overall

consumer price inflation and wage inflation, LTCI consumers are increasingly demanding coverage that contains an inflation adjustment, leading LTCI providers to seek inflation protection well in excess of overall inflation.

Taken together, the future prospects for LTCI providers suggest significant demand in the use of derivatives for hedging purposes. For those insurers that are also BHCs, such as MetLife, having more derivatives on the balance sheet implies increasing capital requirements to maintain capital ratios above regulatory minimums. In other words, contrary to regulatory intent, required capital could increase when a provider attempts to mitigate risk by hedging future LTCI liabilities. In light of these challenges to risk mitigation, it is hard to imagine the LTCI business being viable without an ability to spread medical inflation risk over a broad range of investors—a vital assumption underlying the pay-as-you-go structure employed by both private insurance companies and the CLASS Act. In both cases, ongoing large premium increases seem to be on the horizon, ultimately reducing demand and exacerbating adverse selection.

FURTHER DEVELOPMENTS AND THOUGHTS

Faced with ballooning liabilities, firms resort to plan freezes

MetLife’s exit process merely ceased acceptance of new enrollments; previously written contracts would continue to be honored. This was akin to processes often employed in the context of frozen pension plans.

While the exact definition of a pension plan “freeze” can vary, freezes typically are characterized by some combination of a cessation of benefit accruals (a “hard freeze”) or closure to new entrants (a “soft freeze”). In many cases, pension plan freezes have preceded either a termination or restructuring of the firm’s pension plan offerings. The Government Accountability Office (GAO) produced two studies devoted to this topic: the first examining the implications and risks to the Pension Benefit Guaranty Corporation (GAO 2008), the second considering recent interest (and associated risks) by third-party financial institutions in taking over sponsorship of hard-frozen plans (GAO 2009).

In the case of defined benefit pension plans, it was the plan sponsor that decided to implement the freeze. What is interesting in the LTCI instance is that rather than wait for individual companies to freeze or terminate their LTCI plans, one of the largest insurers has proactively declared a soft freeze on all of the plans it oversees.

The 2008 GAO study found that sponsors' most oft-cited reason for freezing their pension plan was "Annual contributions needed to satisfy funding requirements and their impact on cash flows," followed by "unpredictability/volatility of plan funding requirements." Such concerns apply even more forcefully in the LTCI context due to promised inflation-adjusted benefits and the uncertainty surrounding LTC inflation.

In other countries, notably the UK, financial intermediation has created a solution to the market disruption that a freeze creates, with third-party financial firms taking over sponsorship of hard-frozen pension plans via a swap-like arrangement. Typically in such arrangements, the third-party firm receives an upfront lump-sum payment in exchange for the promise to supply necessary future benefit

cash flows. Similar arrangements do not appear likely to emerge in the U.S., as a result of the 2008 IRS ruling indicating such an arrangement would violate the rule that a plan's assets be used "for the exclusive benefit of plan participants and their beneficiaries."³ Thus, it is unclear private-sector financial intermediation will be able to provide alternatives in the face of LTCI exits. As noted above, Secretary Sebelius' letter similarly indicates that public-sector alternatives also are unlikely to fill the void.

CONCLUSIONS

The population is aging, LTC costs and needs are rising, and even the largest insurance companies are facing difficulty pricing and hedging risks associated with sustained provision of LTCI. For those providers that are also BHCs, the capital implications of derivatives-based hedging creates additional challenges that will likely drive them to exit or curtail involvement in this market. Specifically, while derivatives embed leverage that can in some circumstances increase risk, leverage also provides one of the few mechanisms for insurance companies to hedge long-dated liabilities that outpace inflation.

In recent years, while major changes to both healthcare legislation and banking regulation have developed simultaneously, to a large extent they have occurred separately. Yet the aging population, its projected healthcare needs, and associated escalating costs pose significant challenges to future economic stability. In attempting to prevent unbridled risk-taking, future regulatory capital policy must take care not to inhibit risk-mitigation that could adversely affect the availability of much-needed insurance products that reduce uncertainty for individual households, particularly in light of increasing demand for these products as the population ages.

Letters commenting on this piece or others may be submitted at <http://www.bepress.com/cgi/submit.cgi?context=ev>.

NOTES

1. The full letter, as well as the associated report, is available at www.hhs.gov/secretary/letter10142011.html.
2. http://www.ffiec.gov/nicpubweb/NICDataCache/BHCPR/BHCPR_2945824_20110630.PDF.
3. See IRS Rev. Rul. 2008-45, August 25, 2008, available at http://www.irs.gov/irb/2008-34_IRB/ar07.html.

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