



# The Market for Long-Term Care Insurance and Systemic Risk

**Robin L. Lumsdaine**

January 14, 2011

The private long-term care insurance (LTCI) market may be under serious threat, as evidenced by MetLife's decision to exit the business despite demographic projections suggesting growing demand for such products. Ironically, systemic risk considerations in the form of new capital requirements and financial regulation could discourage participation by some of the largest insurance providers, dealing a destabilizing blow to the viability of this important market.

It's easy to have paid little attention to the MetLife exit story: markets were still digesting QE2, Euro-zone CDS were at record highs – even MetLife didn't deem it worthy of inclusion in its list of "financial press releases" on the MetLife website (it is instead in their "All Press Releases" list). Among those that did take notice, focus was primarily on what MetLife's exit meant for consumers. In this note, we highlight how this story relates to the debate on systemically-important institutions – an aspect that to the best of our knowledge has been largely overlooked.

## POTENTIAL CAPITAL IMPLICATIONS

### Point #1: MetLife is a Bank Holding Company (BHC)

- As it is for all bank holding companies, the Federal Reserve is MetLife's primary regulator.
- Unlike some of its industry competitors (e.g., Hartford Financial, Lincoln National) that became BHCs in order to have access to the Fed's lending facilities, MetLife was a BHC well before the onset of the recent financial crisis.
- In fact, MetLife is the 7th largest BHC, with total consolidated assets of more than \$600bn as of 9/30/10.

### Point #2: MetLife's size should qualify it for Basel II Capital Treatment

- There is some ambiguity as to whether MetLife belongs to the group of "mandatory" BHCs subject to US Basel II rules. In particular, it has not been included in any "unofficial" list of mandatory Basel II banks (see, e.g., the summary findings of the Fourth Quantitative Impact Study (QIS-4), GAO (2007)).<sup>1</sup>
- Yet MetLife was included in the list of 19 firms subject to the Federal Reserve's "stress tests" in May 2009, suggesting its systemic importance. It passed; despite having one of

---

<sup>1</sup> United States Government Accountability Office, "Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework," (GAO-07-253), February 2007



the lowest tier 1 to risk-weighted assets ratios (the 2nd lowest, behind Wells Fargo), it had a healthy amount of tier 1 common capital (deemed to be the “preferred” type of tier 1 capital).

- In addition, back in April 2007, MetLife engaged Kamakura to assist with calculation and reporting of Basel II capital requirements

### **Point #3: The Capital Implications of the LTCI Business**

- On November 4, 2010, exactly one week before its LTCI exit announcement, MetLife filed its quarterly 10-Q report with the SEC and stated (page 128): “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.”
- MetLife makes extensive use of derivatives contracts – exactly the asset class that is facing more stringent capital requirements under Basel II/III. Yet unlike many other BHCs, MetLife’s derivatives exposures are almost entirely for hedging purposes, for example to protect against the uncertainty embedded in long-dated liabilities such as LTCI. Therefore, these derivatives are intended to be held rather than traded, and hence, they are both on-balance-sheet and subject to significant capital requirements.

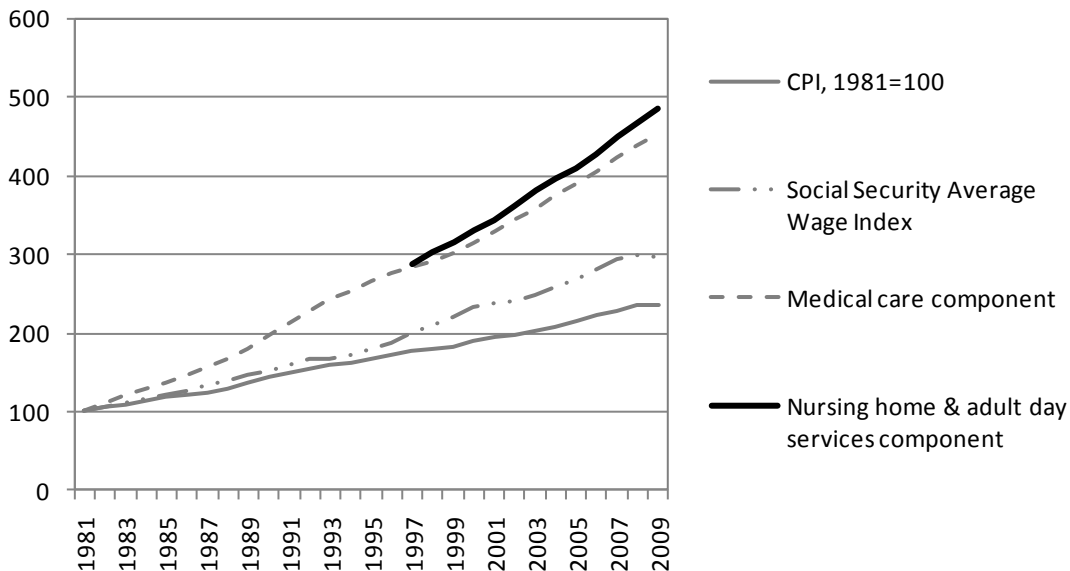
### **Point #4: The Difficulty of Hedging Long-Dated Liabilities that are Outpacing Inflation**

- MetLife’s decision to exit the LTCI business came on the heels of its acquisition of AIG subsidiary ALICO for \$16.2bn. In its press release, MetLife cited “the financial challenges facing the LTCI industry in the current environment” as the reason for the exit. These challenges no doubt include tremendous uncertainty regarding claims and escalating costs far into the future.
- For over three decades, medical care costs have outpaced both overall consumer price inflation and average wages (see Figure 1 below). The implications of this are two-fold: (1) LTCI consumers are increasingly selecting coverage that contains an inflation protection component; (2) LTCI providers face an increasing need for inflation protection well in excess of overall CPI. It is hard to imagine the LTCI business being viable without an ability to spread medical inflation risk over a broad range of investors – in particular, shifting the risk to the current pool of policyholders via ongoing premium increases is not sustainable.
- 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, more derivatives on the balance sheet implies increasing capital



requirements to maintain capital ratios above regulatory minimums. In other words, required capital would go up, rather than down, when a provider hedges future LTCI liabilities. It's no wonder MetLife decided to exit.

**Figure 1: LTC vs other inflation components**



Source: Author's calculations from Bureau of Labor Statistics and Social Security Administration data

## FURTHER DEVELOPMENTS AND THOUGHTS

### Faced with ballooning liabilities, firms resort to plan freezes

The exit process was outlined as follows: MetLife stopped accepting new applications for individual LTCI coverage on Dec 30, 2010; it further will discontinue new enrollments into existing group and multi-life plans in 2011, with exact timing depending on existing contractual obligations. Previously written contracts will continue to be honored. We have seen descriptions like this many times – in the context of frozen pension plans.

While the exact definition of a pension plan “freeze” can vary, they 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<sup>2</sup> on this topic: the first examining the implications and risks to the Pension

<sup>2</sup> United States Government Accountability Office, “Defined Benefit Pensions: Plan Freezes Affect Millions of Participants and May Pose Retirement Income Challenges,” (GAO-08-817), July 2008; United States Government Accountability Office, “Defined Benefit Pensions: Proposed Plan Buyouts by Financial Firms Pose Potential Risks and Benefits,” (GAO-09-207), March 2009.



Benefit Guaranty Corporation, the second considering recent interest (and associated risks) by third-party financial institutions in taking over sponsorship of hard-frozen plans.

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 they oversee.

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, with third-party financial firms taking over sponsorship of hard-frozen pension plans via a swap-like arrangement.<sup>3</sup> Similar arrangements do not appear likely to emerge in the US.

## CONCLUSIONS

The issues raised here extend well beyond a MetLife case-study. 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. That leaves the non-BHC providers, whose need for derivatives-based hedging of LTCI liabilities could ultimately sweep them into the category of systemically-important nonbanks.

*With thanks to Larry Goodman and Bruce Tuckman for helpful comments.*

URLs for press releases cited:

<http://www.metlife.com/about/press-room/us-press-releases/2010/index.html?compID=31515>

<http://www.kamakuraco.com/April102007PressRelease.aspx>

---

*The Center for Financial Stability (CFS) is a private, nonprofit institution focusing on global finance and markets. Its research is nonpartisan. This publication reflects the judgments and recommendations of the author(s). They do not necessarily represent the views of Members of the Advisory Board or Trustees, whose involvement in no way should be interpreted as an endorsement of the report by either themselves or the organizations with which they are affiliated.*

---

<sup>3</sup> Typically the third-party firm receives an upfront lump-sum payment in exchange for the promise to supply necessary future benefit cash flows.