Risk Analysis and Reserving Policies for Entry Fee CCRCs

ZIEGLER AAHSA NATIONAL SENIOR LIVING CFO WORKSHOP

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AV POWELL
Consulting Actuary
AV Powell & Associates LLC

Objectives

- To provide attendees with answers to:
  - What are and how should adequate reserves determined?
  - Is there an upper limit on the level of reserve?
  - Can a community accumulate too much?
  - What is the appropriate rate of growth in reserves?
  - What are appropriate uses for reserves?
- To stimulate discussion on the adequacy of reserves!

Presentation Outline

Section 1 - Why Reserve?

Section 2 - GAAP versus Actuarial Reserves

Section 3 - Four (4) Reserve Issues

Questions & Answers

Section 1

Why Reserve?

Definition of Reserves?

Reserves are the portion of a CCRC's accumulated assets that are designated for a specific purpose

Why Do We Need Reserves?

- Vagaries of cash flows or adverse experience
- Financing covenants
- Regulatory obligations
- Smoothing fee adjustments
- Covering liabilities if prepay costs

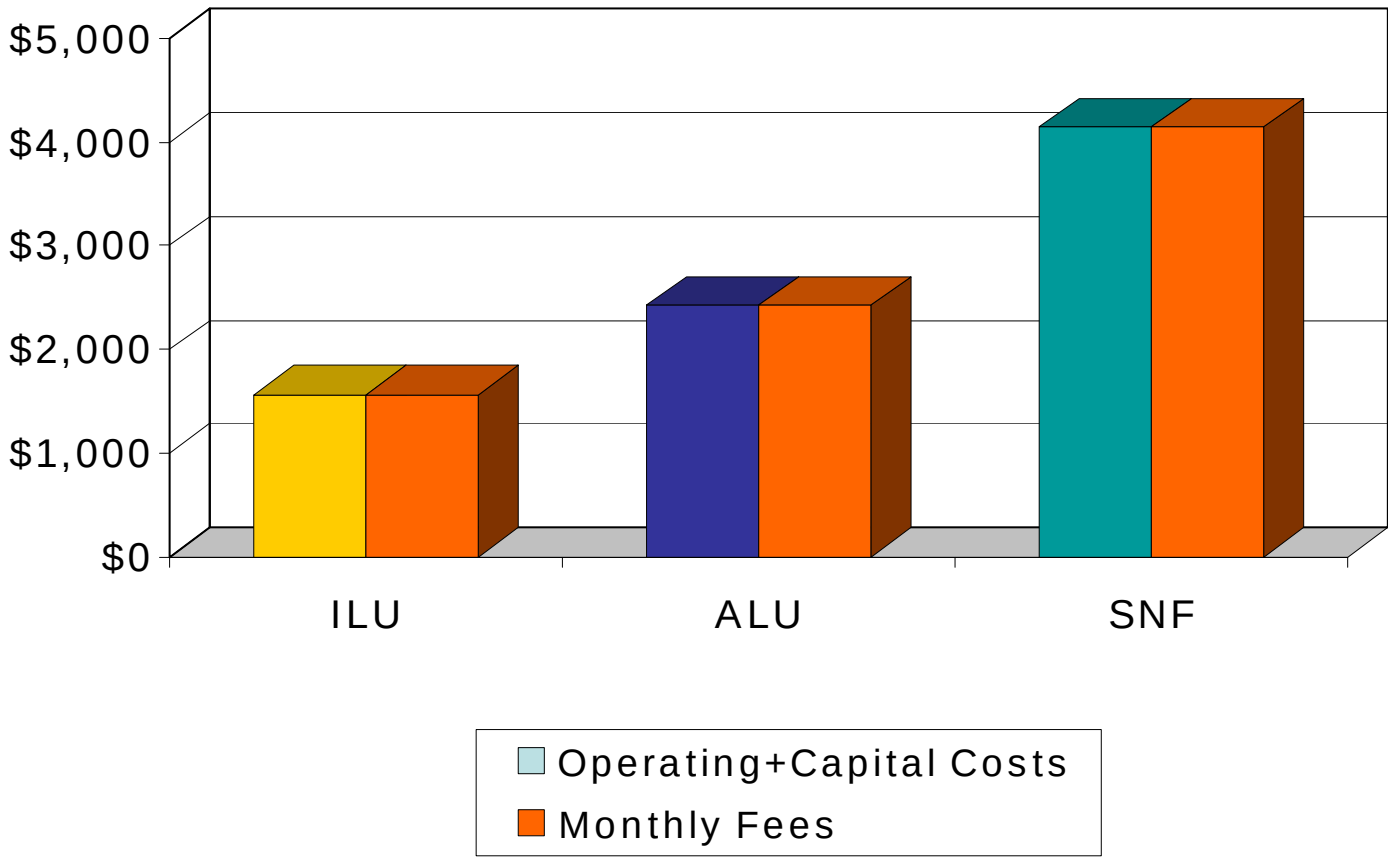
Section 2

GAAP versus Actuarial Reserves

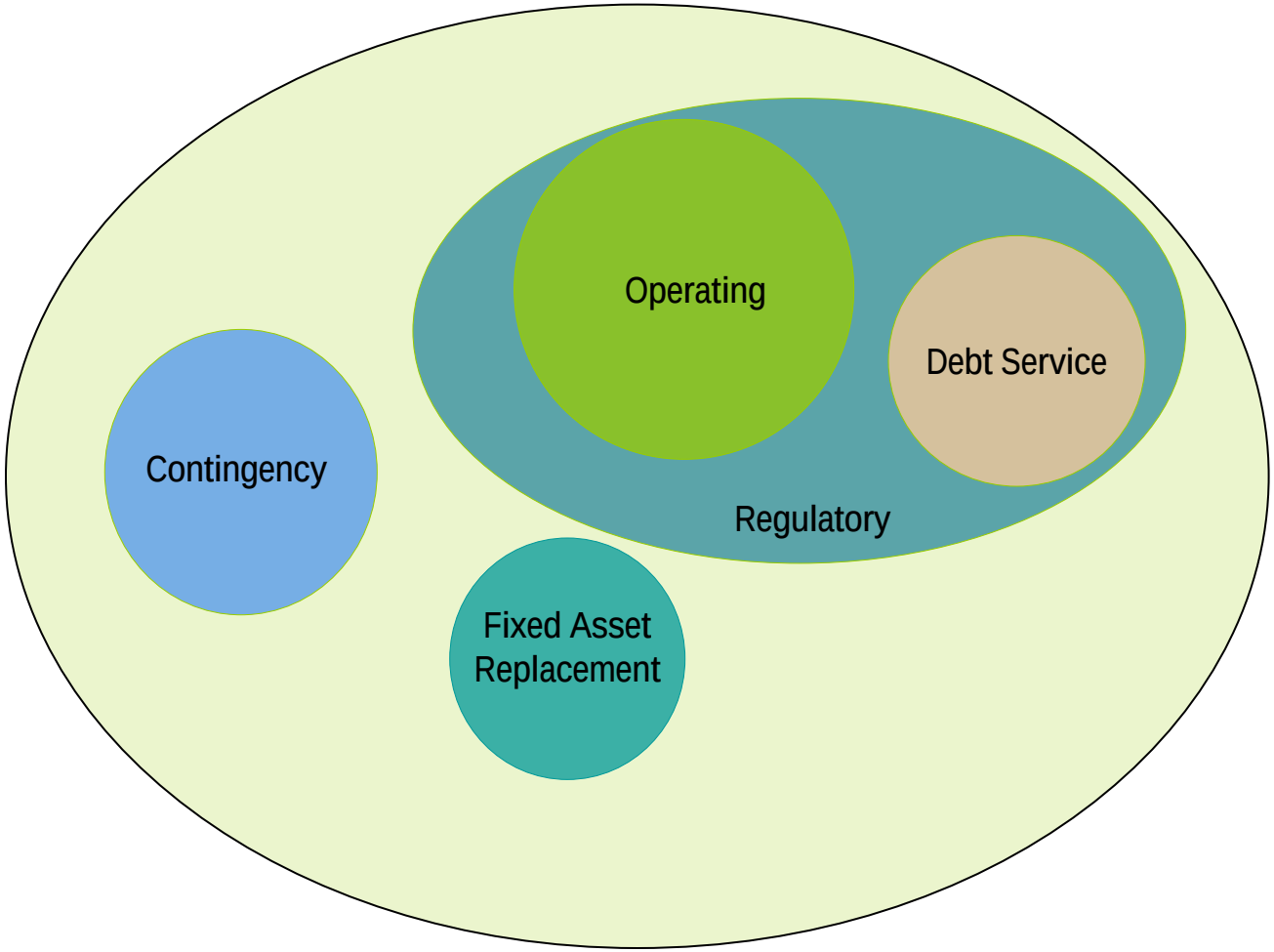
GAAP Reserves Typically Cover

- Contingency
- Debt service
- Operating
- Fixed asset replacement
- Others as defined by the Board…

No Actuarial Liabilities for Rental



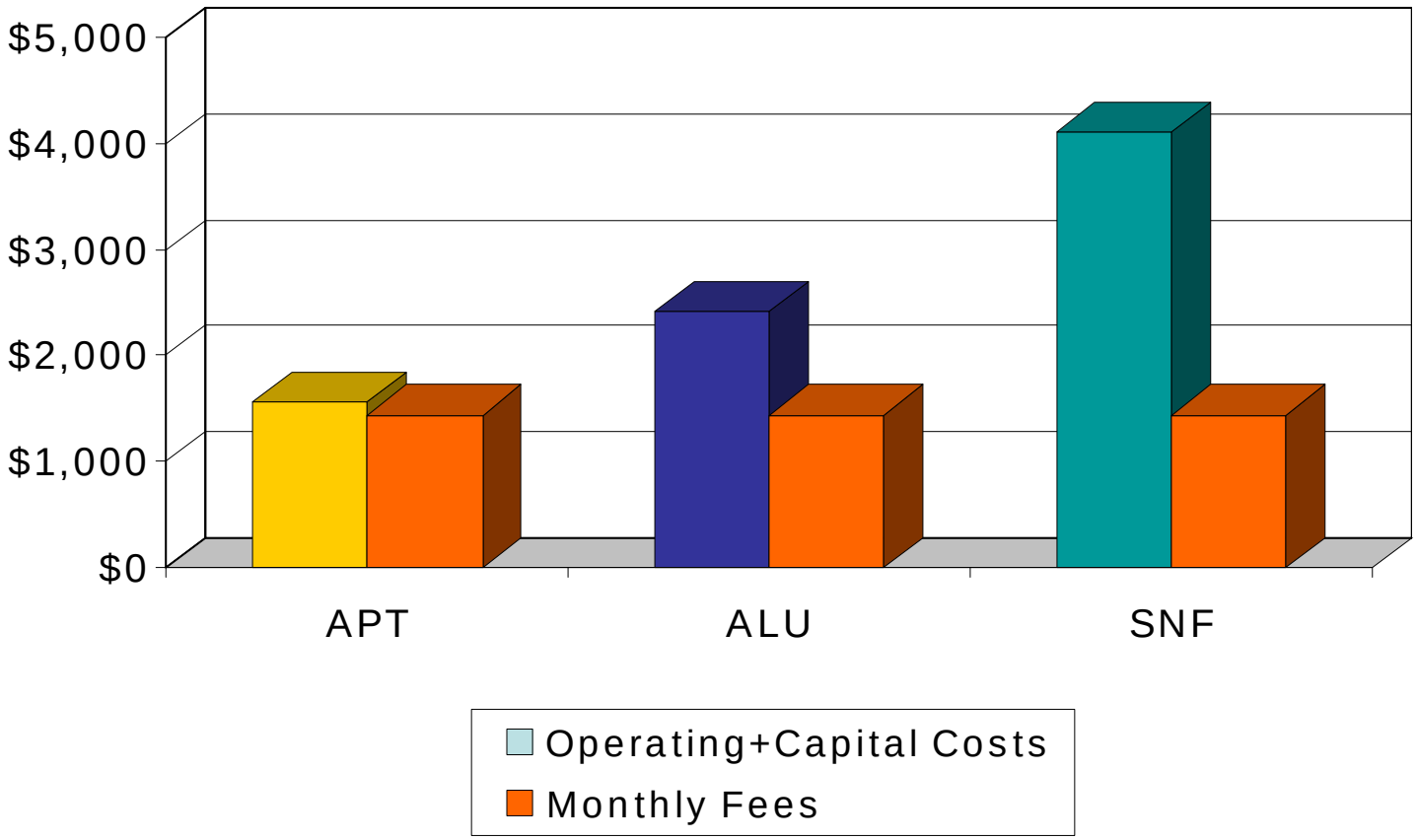
GAAP is Consistent with Rental



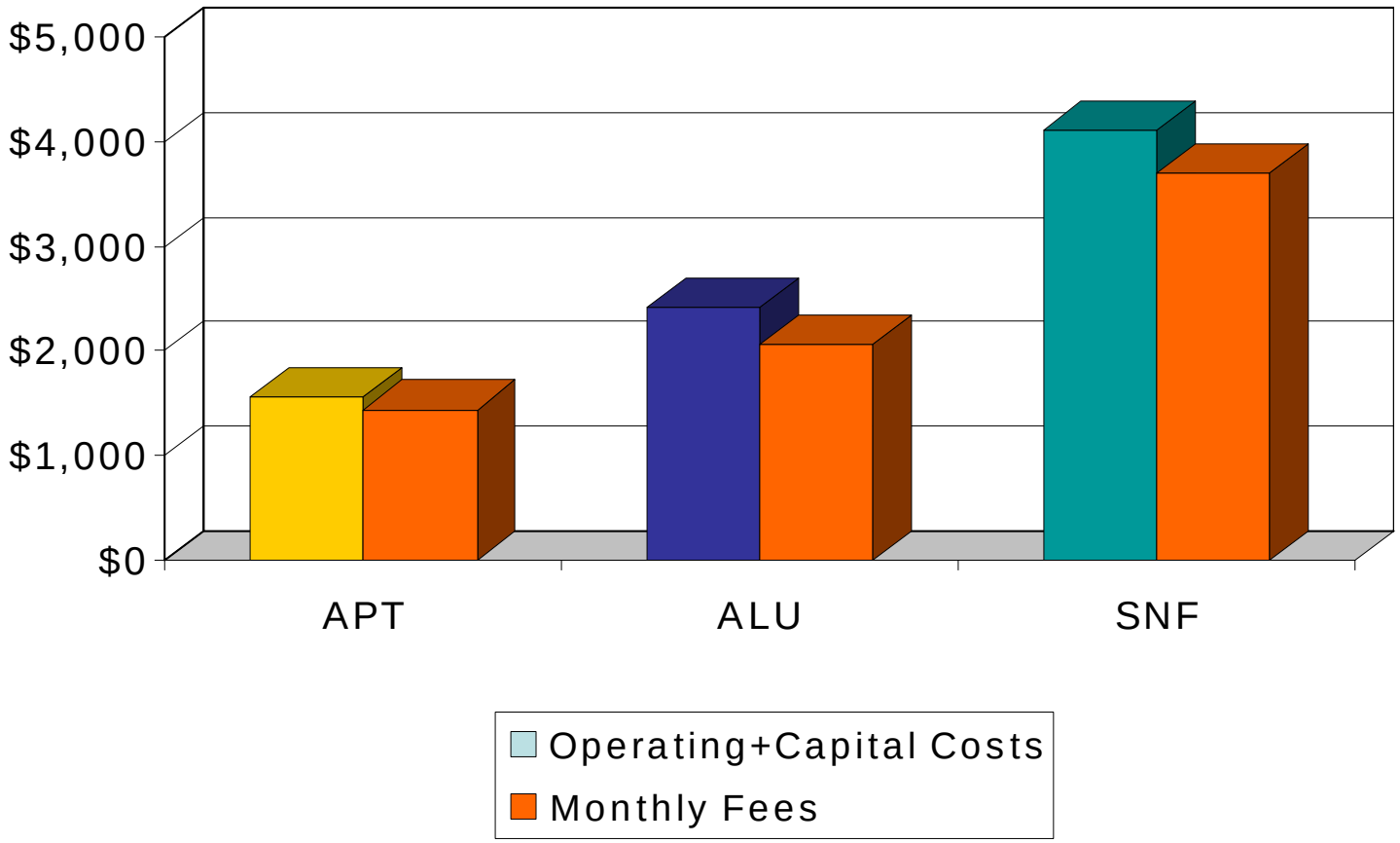
Entry Fees Give Rise to Liabilities

- Contingency
- Debt service
- Operating
- Fixed asset replacement
- **Refund, actuarial liabilities, benevolence**
- Others as defined by the Board…

Type A Has Large Liabilities



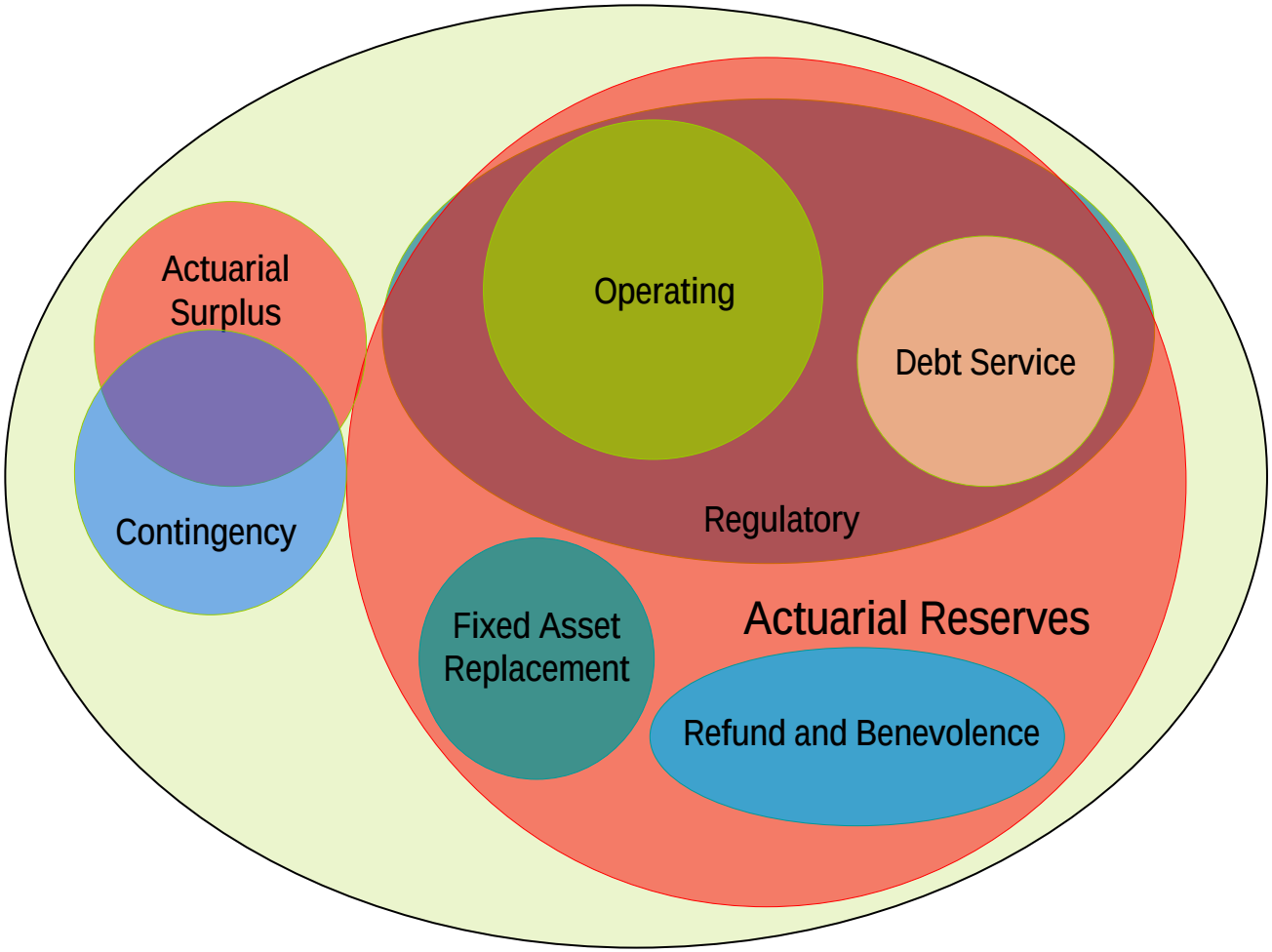
Type B/C Have Moderate Liabilities



Actuarial Reserves are Substantial

- If adopt ASOP#3 and 100% funded status
- Typical liability is $300K to $600K/contract
- Average of 250 contracts/CCRC
- Entry fees cover 30% of costs
- 100% funded reserves range from $22M to $45M

Do Reserves Overlap?



Section 3

Four (4) Reserve Issues

Four (4) Reserve Issues

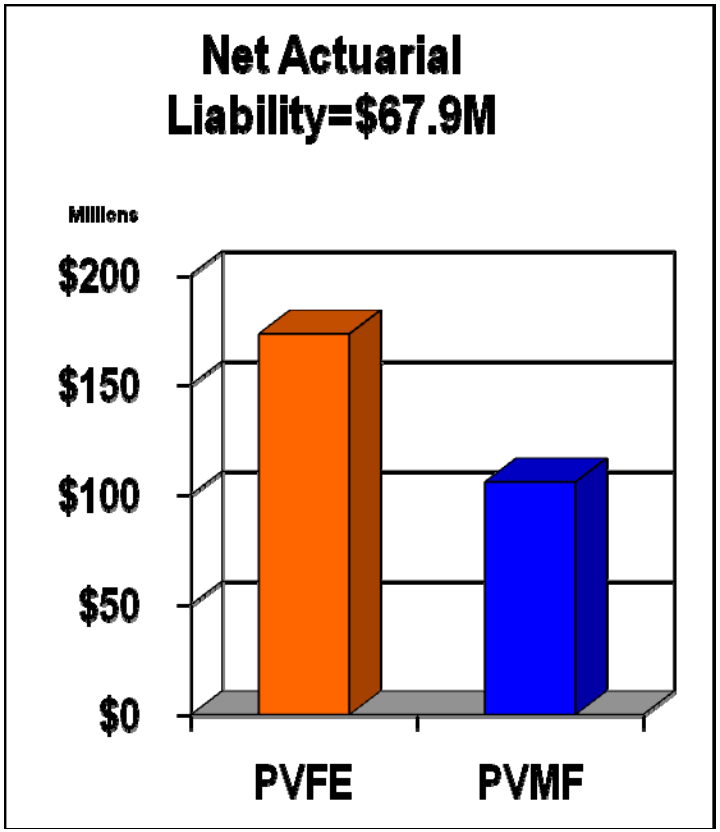
- Calculate
- Growth
- Upper limit
- Use

Calculating Adequate Reserves

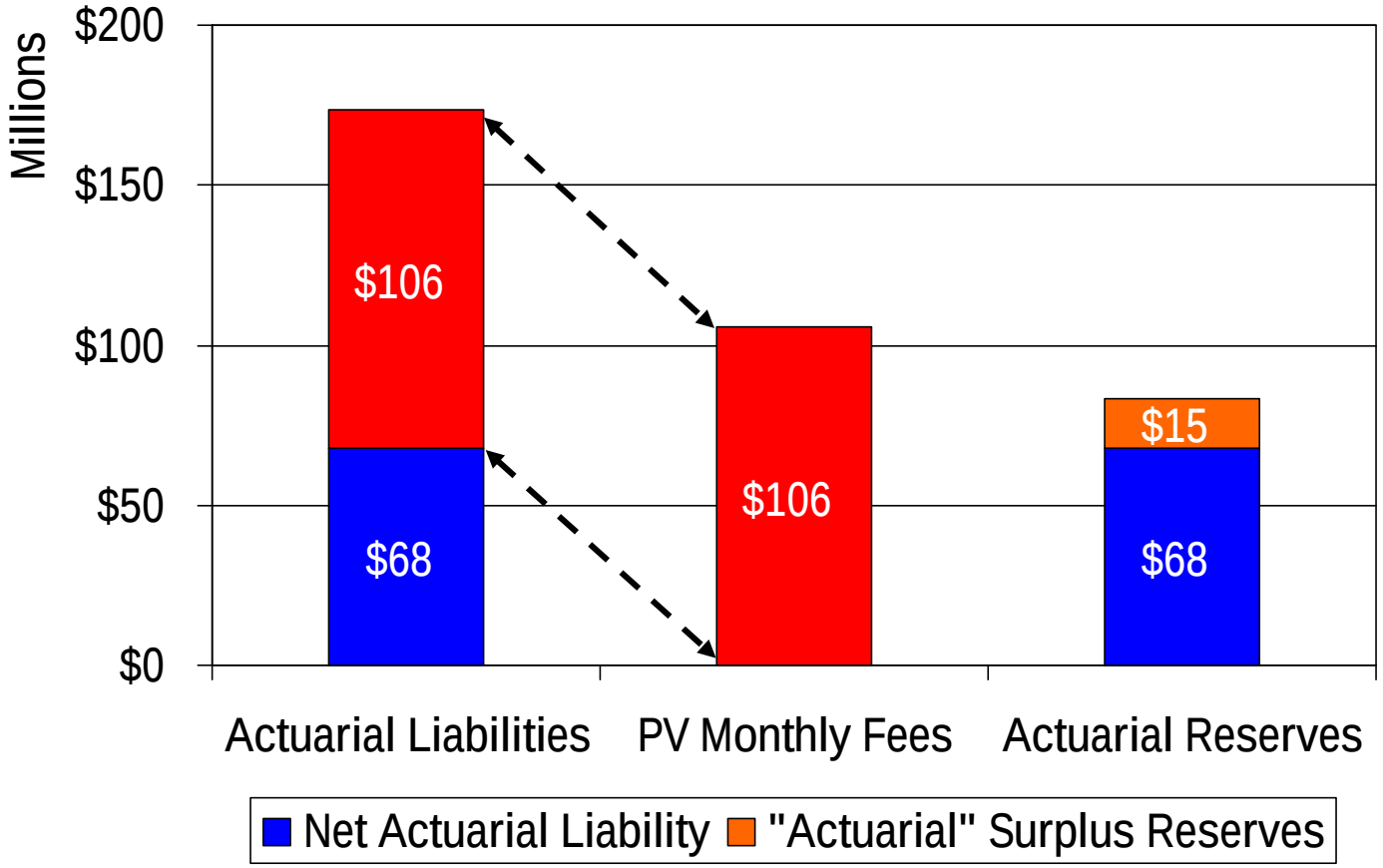
- Confirm reserves > net actuarial liability
- Set fees to generate actuarial surplus, aka surplus reserves, to:
  - Cover potential variation in liabilities
  - Based on acceptable level of risk

Actuarial Reserves > ?

- Defined as cash, investments, fixed assets minus certain liabilities plus debt
- Should cover net actuarial liability which equals difference between future lifetime costs and monthly fees



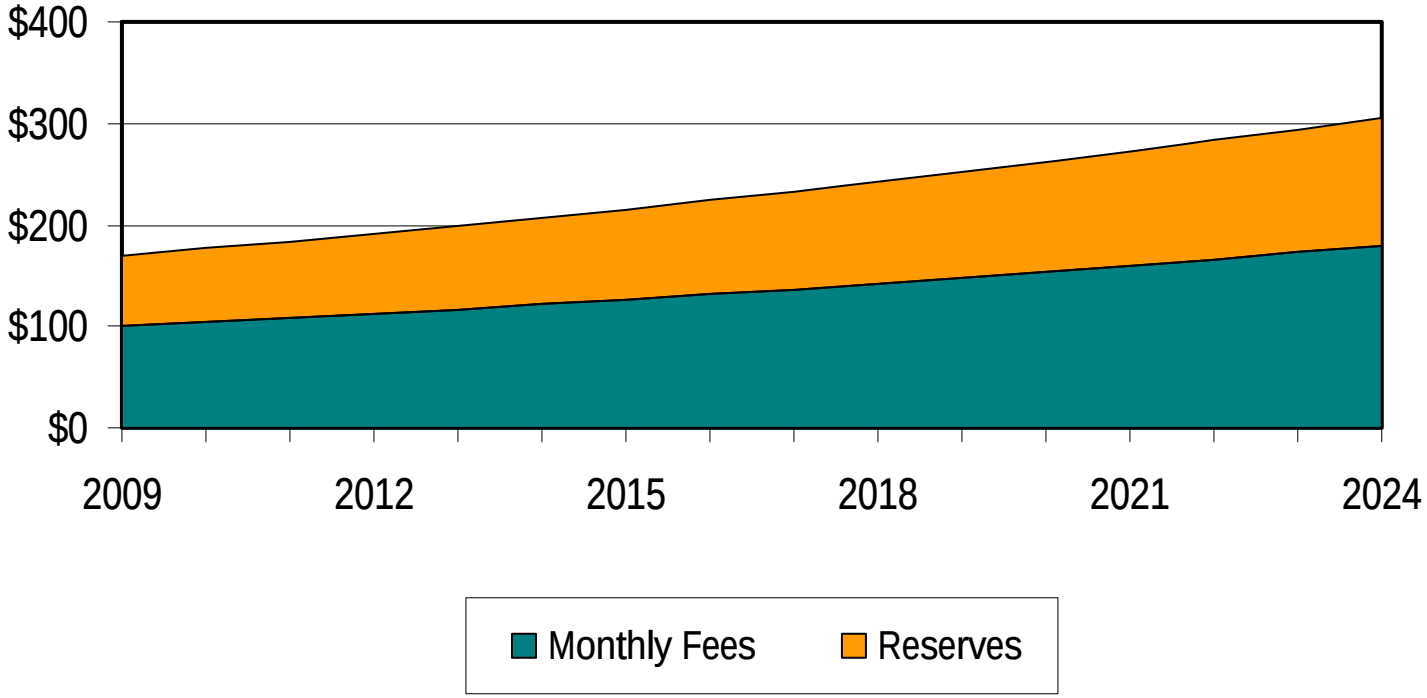
Surplus ε Actuarial Reserves



Surplus Reserves 96% Allocated

Actuarial surplus reserves	$ 15,352,643
5% occupancy drop	18.5%
1% benevolence	6.9%
50% higher capital expend.	43.1%
25% higher refunds	1.0%
3% earnings drop	26.4%

Reserves Should Increase



Market Limits Surplus Reserves

- Objective is to reduce risk of failure
- Could set fees to fund “worst case” scenario
- But higher fees may impact occupancy

Specific Use Needs in Operations

- If experience unfavorable, YES
- If used, reserves should be re-funded in future
- Unlikely that absolute reserves reduce in future

Prefunded Capital Replacements

- YES for portion of net actuarial liability
- If needs exceed expectations, YES

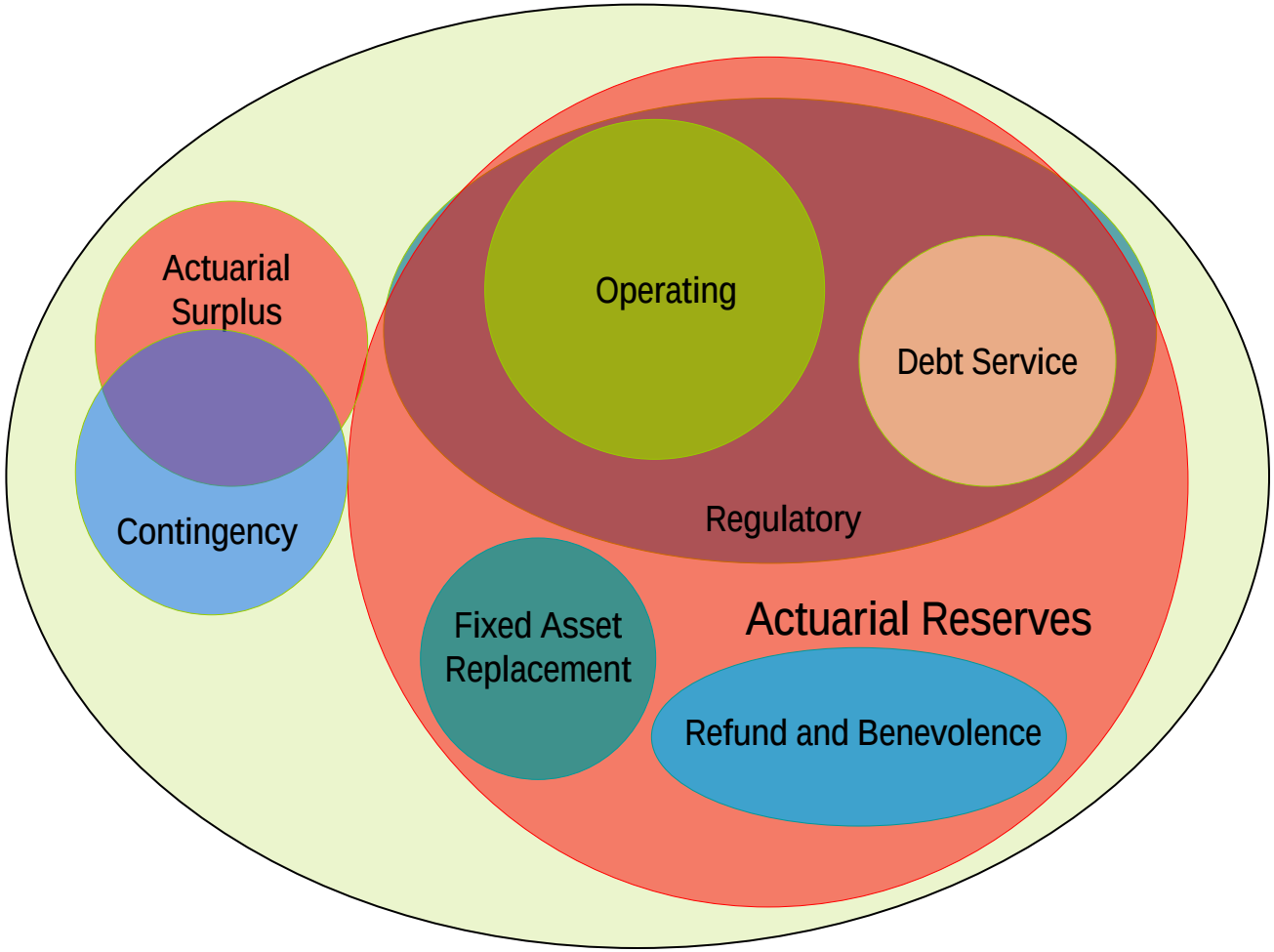
Use as Seed Money?
Consider Investment Risks?

- Are surplus reserves more than target?
- Policy on refunding draws from reserves
  - Replenish or not
  - Draw interest rate covers actuarial valuation discount rate plus charge for repayment risk

Section 4

Summary

Do Reserves Overlap?



GAAP vs GAAPP Reserves

Traditional	Actuarial Counterpart
Occupancy	Actuarial surplus reserve
Interest/inflation relationship	Actuarial surplus reserve
Debt service	Net actuarial liability
Operations	Net actuarial liability

GAAP vs GAAPP Reserves (cont'd)

Traditional	Actuarial Counterpart
Building replacement	Actuarial surplus reserve + net actuarial liability
Equipment replacement	Actuarial surplus reserve + net actuarial liability
Refunds	Actuarial surplus reserve + net actuarial liability
Benevolence	Actuarial surplus reserve or explicit projections

Questions About Reserves

Question	Net Actuarial Liab.	Surplus Reserve
Calculation	Actuarial valuation	Ad hoc or what-if sensitivity
Limits	None except for market	Risk tolerance
Changes	Internal inflation; decrease unlikely	Same as actuarial; never < $0
Operations; capital exps; seed money	Implicit in calculation	If experience warrants

Questions & Answers

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