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Z-News readers are well aware of the critical scrutiny of the financial well-being of continuing care retirement communities (CCRCs) recently administered by the Senate Special Committee on Aging and the General Accounting Office; such was highlighted in last week's **Z-News** feature, "From the Desk of Dan Hermann." Featured prominently in the testimonies presented to the Senate Special Committee on Aging at its July 21 hearing is the topic of the actuarial soundness of CCRCs, prompting A.V. Powell, one of the industry's leading actuarial experts, to express his thoughts on the critical role of actuarial-based pricing for entrance fee CCRCs. Ziegler is pleased to present Mr. Powell's comments in their entirety below, not so much as an endorsement of the views expressed, but as a recognition of the importance of the topic and the value of expert insights on so complex a matter. We hope his essay prompts additional thought and discussion.

FEATURED ARTICLE

ACTUARIAL RISKS ARE NOT LIMITED TO TYPE A AND B CONTRACTS

As a student of the CCRC¹ industry, I watched and read with interest the findings of the GAO and the Senate Special Committee on Aging studies. My take on their findings is that the few CCRCs that have had financial difficulties that resulted in bankruptcy are exceptions to the overall risk exposure for residents of CCRCs. This outcome is not surprising based on my 31 years of experience in dealing with 25% of the industry.

However, I was surprised to hear testimony from two witnesses in response to Senator Franken's question² about the value and need for actuarial studies for CCRCs. In my opinion, there is a misconception that pervades the industry similar to the misinterpretation of the GAAP calculation for the obligation to provide future services (more on that issue in another article). It is unclear to me why many believe that the application of actuarial science and corresponding mathematics don't apply to Type C entry fee contracts. These statements are interesting especially in light of the fact that the recent bankruptcies were CCRCs that predominately offered Type C contracts and, as a result, were the primary catalysts in the evaluation of the effectiveness of CCRC regulation.

Actuarial science is a statistical tool that generates projections to determine the advance funding of future obligations based on various contingencies, such as mortality,

morbidity (health care), and property and casualty. Traditionally, actuarial science is applied to determine pricing for life insurance, annuity (i.e., social security), and long-term care insurance (LTCi) products. If one were to follow the logic touted for CCRCs, then the only application of actuarial techniques would be for LTCi since it covers health care risk.

All entry fee CCRC contracts contain actuarial risks because entry fees are prepaying a component of future costs. Therefore, actuarial analysis is needed to determine whether those organizations are solvent. Type A and B contracts contain components of LTCi, and actuarial analysis is used to estimate health care contingencies. Entry fees for all CCRC contracts include prepayment of a portion of future operating and/or capital costs which corresponds to annuity risk and longevity contingencies. Refund provisions, especially fully refundable entry fees, for all CCRC contracts are identical to whole life insurance and require actuarial analysis to determine mortality contingencies.

In fact, CCRCs have always been trail blazers in offering products for small groups that incorporate actuarial principles — starting with managed care in extensive lifecare contracts before the insurance industry actively began marketing LTCi policies to seniors. More recently, the industry has lead

the way with refundable entry fees by offering whole life insurance to seniors who have difficulty purchasing such policies at age 80 or older.

It appears that some confusion occurs with the use of the "fee-for-service" label. This terminology is often associated with Type C entry fee contracts that offer refundable entry fees. Most refundable contracts include a provision that payment of the refund will be withheld until the unit is reoccupied. Also, some contracts allow residents to draw down on their refund if they can't pay the higher monthly fees when they need higher cost health care services.

Neither the timing of the refund payment nor the source of cash for the refund eliminates the actuarial refund liability. If one decides to ignore the actuarial refund liabilities and use the next occupant's entry fee to pay the refund instead of setting aside a portion of the current entry fee to cover the anticipated refund liability, then it is likely that those Type C contracts will be underpriced. This gives the prospective resident a false sense of financial security in regard to the CCRC's overall solvency and ability to make good on its contractual obligations.

In other words, for many residents the promise of refundable entry fees can be empty especially if multiple refund options are offered to new entrants (i.e., there is no guarantee that

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their unit will be reoccupied by similar refund provisions) or if a CCRC is in a fill-up or low occupancy stage where the ILU is not resold. However, if the CCRC funded the refund liabilities as determined by an actuarial study, then monies would be available to make good on those promises when death or move-out occurs without delay.

Although many in the industry believe that Type C fee-for-service entry fee contracts do not have actuarial risks, this is simply not true. Actuarial risks are a consequence of the refund provisions and residents' potential inability to pay monthly fees. By allowing these Type C contracts to be excluded from the requirements of actuarial funding, it is possible that these contracts will be underpriced leading to a competitive advantage compared with Type A or Type B

contracts that are required to meet actuarial funding requirements. This loophole could lead to reducing the number of CCRCs that provide the popular and economically viable Type A and B options. This means that seniors will have fewer continuing care choices including the option to select one of the best long-term care policies available today (the "true" lifecare in Type A extensive contracts).

The only CCRC contract that may not include actuarial risk is a rental, or Type D contract. For these contracts there is no up-front prepayment of costs, and monthly fees are set to cover both operating and capital expenses. But even 100% rental CCRCs can benefit from actuarial analysis to evaluate the liabilities associated with residents outliving their financial resources.

It is a good finding that both the Senate Special Committee on Aging and GAO gave the CCRC industry a clean bill of health. Nevertheless, there is still a need for the industry-wide application of actuarial science to provide residents, Boards, and management with the necessary information to ensure the solvency of their organization and ability to set fees to provide services promised by continuing care contracts. Actuarial studies prepared in accordance with the Actuarial Standards of Practice No. 3 for CCRCs were designed to and will provide this information for all models of continuing care contracts.

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1 The term CCRC was first coined by Mr. Walter Shur, former Chief Actuary of New York Life Insurance Company, in a Pension Research Council textbook that I co-authored in 1981.

2 Minutes 75 through 82 in the Senate testimony by Mr. David Erickson and Ms. Alicia Cackley.