# COVID-19 May Fix GE's Long-Term Care Problem

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## Summary

- In early 2018, GE took a $9.5 billion pre-tax charge and announced that it would have to add nearly $15 billion to its long-term care insurance reserves by 2024.
- Many investors have continued to worry that GE would eventually need to set aside even greater reserves.
- The COVID-19 pandemic appears to have sparked an uptick in long-term care policy terminations, reducing future liabilities.
- With long-term care premiums rising and skilled-nursing facilities increasingly seeming dangerous, policy terminations could continue in the quarters ahead.
- GE stock has fallen too far in 2020.

**General Electric**'s (NYSE:GE) recently reported Q2 results were predictably bad. The COVID-19 pandemic hurt every one of its major operating units: most notably its prized GE Aviation business. GE Aviation posted a 44% revenue decline and swung to a $680 million operating loss, compared to a $1.4 billion profit in Q2 2019.

For the company as a whole, revenue fell 24% year over year (20% on an organic basis) to $17.7 billion. GE reported an adjusted net loss of $0.15 per share, compared to adjusted EPS of $0.16 a year earlier. Industrial free cash flow was -$2.1 billion, bringing year-to-date cash burn to $4.3 billion: nearly double the $2.2 billion burned in the first half of 2019.

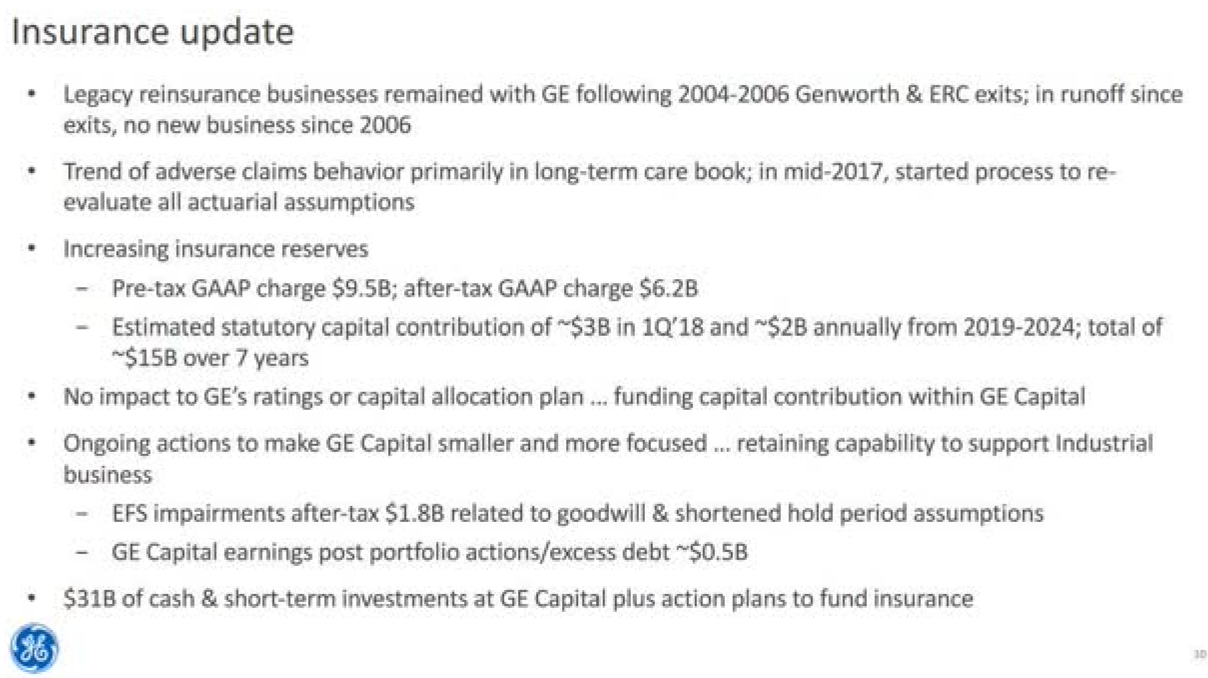
Yet for all of this disruption to General Electric's core business, the pandemic could help the company in one important way. In recent years, investor concern about GE's residual long-term care liabilities has weighed heavily on the stock price. However, the COVID-19 pandemic may be triggering a change in policyholder behavior that could decisively alter the narrative and reduce the likelihood that investors will get nasty surprises from the run-off insurance business in the future.

## The big 2018 shocker

General Electric's exposure to long-term care insurance comes from its GE Capital unit, which former CEO Jack Welch expanded dramatically during the 1980s and 1990s. General Electric divested most of its insurance business between 2004 and 2006, but retained some liabilities (particularly long-term care reinsurance), with plans to manage them in "runoff" mode.

Three years ago, management warned investors that based on new claims data, GE's insurance subsidiaries might not have sufficient reserves to meet future long-term care claims. Many investors expected a charge that might total several billion dollars.

Instead, on Jan. 16, 2018, GE announced a massive $9.5 billion GAAP pre-tax charge to address the premium deficiency. On a cash basis, the impact was even greater, as the statutory calculations are more conservative than GAAP. General Electric agreed to contribute the required sum of nearly $15 billion to its reserves between 2018 and 2024. So far, it has added about half of that amount to its reserves.




(Source: GE Q4 2017 Earnings Presentation, slide 10)

Not surprisingly, this revelation shook investors' faith in GE's accounting practices. It even led to charges of fraud by serial whistleblower Harry Markopolos, although those allegations appear to have been erroneous.

## The (possible) COVID-19 fix

One of several reasons why GE's initial actuarial assumptions proved faulty was that far fewer people have terminated their policies than expected. Insurers assumed that some customers would pay premiums for a while but drop their policies long before they would be likely to need long-term care. In reality, they got far less of this "free money" than they had estimated.

However, during GE's Q2 earnings call last week, CEO Larry Culp stated, "On the long-term care block, we're seeing lower new claims and higher terminations than expected. We believe policyholders are delaying entering care facilities or bringing care into their home."

To be fair, Culp warned that it was too early to draw firm conclusions about what this means in the long run. The drop in new claims may be a short-term phenomenon driven by the pandemic. However, an uptick in terminations would not be very surprising.

First, the COVID-19 pandemic has rampaged through long-term care facilities across the U.S. Long-term care facilities have accounted for more than half of the death toll in many states. It would only be natural for the headlines to give people second thoughts about whether they would ever want to receive care in an assisted living or nursing home environment. Second, long-term care insurers continue to get approval for big rate hikes (albeit not as big as they would like) to make up for the faulty initial underwriting.

Long-term care insurance typically provides some benefits for in-home care, but not to the same extent that it would cover costs for assisted living or a nursing home. As a result, the COVID-19 pandemic may cause some long-term care policyholders to reevaluate whether they would be likely to use their benefits if they needed long-term care (as opposed to being cared for by a family member, for example). Notices of big rate increases would make them even more likely to terminate their policies. An increase in policy terminations would improve the likelihood that GE's existing long-term care reserves will be sufficient.

## What to look for

The big question, of course, is whether the recent uptick in policy terminations will continue as the pandemic takes its toll on long-term care facilities and premiums keep rising. That will help determine whether there will be a significant impact on the insurance unit's financial position.

GE will complete its annual reserve adequacy testing this quarter. That means investors may get a better sense of how the COVID-19 pandemic is impacting its insurance unit when the company releases its next earnings report in late October.

However, more detailed information will become available when GE publishes its 2020 annual report in early 2021. At the end of 2019, GE had approximately 263,000 long-term care policies in force, covering 328,000 lives. That compared to 274,000 policies covering 342,000 lives a year earlier: a 4% year-over-year decrease.

| December 31, 2018 (Dollars in billions, except where noted) | ERAC | UFLIC | Total |
|---|---|---|---|
| Gross GAAP future policy benefit reserves and claim reserves | $ 14.1 | $ 5.9 | $ 19.9 |
| Gross statutory future policy benefit reserves and claim reserves(a) | 23.2 | 7.2 | 30.4 |
| Number of policies in force | 202,000 | 72,000 | 274,000 |
| Number of covered lives in force | 270,000 | 72,000 | 342,000 |
| Average policyholder attained age | 75 | 82 | 77 |
| Gross GAAP future policy benefit reserve per policy (in actual dollars) | $ 60,000 | $ 56,000 | $ 59,000 |
| Gross GAAP future policy benefit reserve per covered life (in actual dollars) | 45,000 | 56,000 | 47,000 |
| Gross statutory future policy benefit reserve per policy (in actual dollars)(a) | 105,000 | 72,000 | 96,000 |
| Gross statutory future policy benefit reserve per covered life (in actual dollars)(a) | 79,000 | 72,000 | 77,000 |
| Percentage of policies with: | | | |
| Lifetime benefit period | 70% | 35% | 60% |
| Inflation protection option | 81% | 91% | 84% |
| Joint lives | 34% | —% | 25% |
| Percentage of policies that are premium paying | 74% | 83% | 76% |
| Policies on claim | 10,000 | 9,200 | 19,200 |

(a) Statutory balances reflect recognition of the estimated remaining statutory increase in reserves of approximately $9 billion through 2023 under the permitted accounting practice discussed further below and in Note 12 to our consolidated financial statements.

| December 31, 2019 (Dollars in billions, except where noted) | ERAC | UFLIC | Total |
|---|---|---|---|
| Gross GAAP future policy benefit reserves and claim reserves | $ 15.2 | $ 5.8 | $ 21.0 |
| Gross statutory future policy benefit reserves and claim reserves(a) | 23.7 | 7.1 | 30.8 |
| Number of policies in force | 196,000 | 67,000 | 263,000 |
| Number of covered lives in force | 261,000 | 67,000 | 328,000 |
| Average policyholder attained age | 75 | 83 | 77 |
| Gross GAAP future policy benefit reserve per policy (in actual dollars) | $ 66,500 | $ 56,000 | $ 64,000 |
| Gross GAAP future policy benefit reserve per covered life (in actual dollars) | 50,000 | 56,000 | 51,000 |
| Gross statutory future policy benefit reserve per policy (in actual dollars)(a) | 109,000 | 74,000 | 100,000 |
| Gross statutory future policy benefit reserve per covered life (in actual dollars)(a) | 81,000 | 74,000 | 80,000 |
| Percentage of policies with: | | | |
| Lifetime benefit period | 70% | 35% | 61% |
| Inflation protection option | 81% | 91% | 84% |
| Joint lives | 34% | —% | 25% |
| Percentage of policies that are premium paying | 73% | 82% | 75% |
| Policies on claim | 10,700 | 9,300 | 20,000 |

(a) Statutory balances reflect recognition of the estimated remaining statutory increase in reserves of approximately $7 billion through 2023 under the permitted accounting practice discussed further below and in Note 12 to our consolidated financial statements.

(Source: GE 2018 Form 10-K, p. 63; GE 2019 Form 10-K, p. 38)

If the decline in total policies and covered lives accelerates significantly in 2020, that would be strong evidence of a meaningful uptick in terminations (and, to a lesser extent, increased mortality due to the pandemic). Subsequent annual reports will show whether policy terminations remain at elevated levels for an extended period of time.

There could also be a smaller short-term benefit from fewer new claims, as the pandemic has led to a drop in admissions to skilled nursing facilities. This can be evaluated based on changes in the number of policies on claim. During 2019, there was a 4% increase, from 19,200 to 20,000.

## Key risks

While the increase in long-term care policy terminations could have a significant positive impact on GE's insurance operations, investors shouldn't rejoice quite yet. For one thing, it's possible that the year-to-date uptick in terminations will quickly fade, leaving little long-term impact.

Additionally, the Fed's intervention to shore up the economy has driven long-term interest rates to new lows. If rates remain severely depressed for an extended period, it will negatively impact future investment returns for the assets supporting GE's insurance liabilities. In a worst-case scenario, that could require GE to set aside additional reserves.

Culp also noted an increase in life insurance claims (probably related to the pandemic) during the Q2 earnings call. So there's some risk that an increase in projected life insurance liabilities could offset any improvement on the long-term care side. That said, statutory reserves are over $30 billion for GE's long-term care policies, compared to $2 billion for life insurance. It's unlikely that life insurance claims would rise enough to have a material impact on the overall insurance business.

The other big risk, of course, is that the core industrial business might not recover from COVID-19. However, as I discussed several months ago, GE Aviation is likely to bounce back from the pandemic relatively quickly. Its growth rate will be slower than what seemed possible a year ago, but a focus on aftermarket services should bring the unit back to profitability next year, even though air travel demand is expected to remain well below 2019 levels. By 2023 or 2024, GE Aviation could be back to earning record profits based on servicing all the engines it has delivered over the past decade.


(Image source: General Electric)

GE's other industrial segments have felt smaller impacts from the pandemic and should recover even faster: especially GE Healthcare. The power and renewables units were in turnaround mode even before COVID-19, but the pandemic has sharpened management's focus on cutting costs and holding the line on pricing. That should pave the way for future margin expansion.

General Electric stock has lost more than half of its value since hitting a new 52-week high in February. With a market cap of just $55 billion, investors seem to fear sustained weak performance for its industrial businesses and continued balance sheet woes. Their worries appear unjustified on both counts.