HEALTH CASE STUDY

National States Insurance Company ("National States" or "the Company")

April 1, 2010: Status—Rehabilitation
November 15, 2011: Status—Liquidation

Root Causes of Insolvency

- Pricing inadequacies for Long-Term Care (LTC) insurance, particularly in the FL market
- Concentration in a single product line, namely LTC
- Lack of strong corporate governance

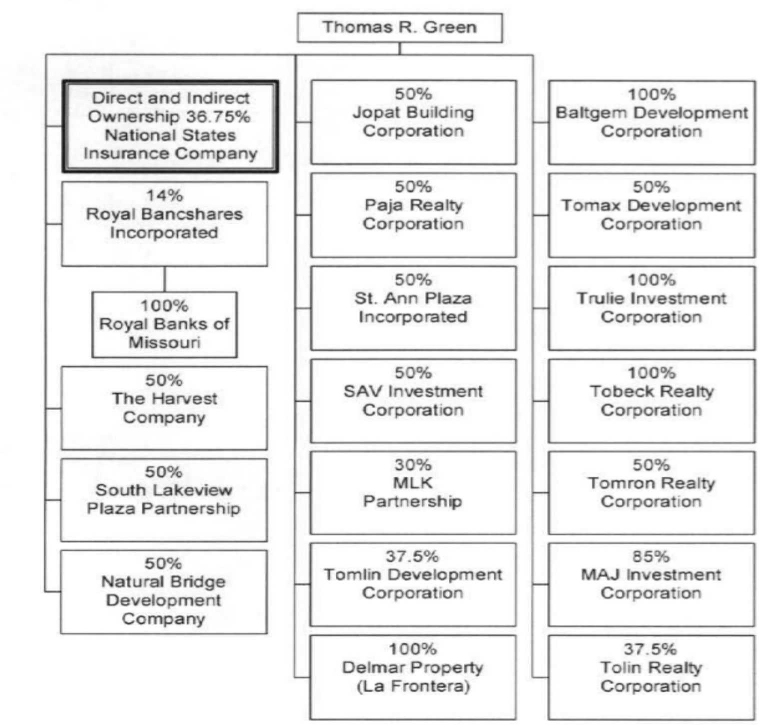
Section I—Background

Company Summary

National States Insurance Company was licensed in 37 states as a life, accident, and health insurer. The company was domiciled in Missouri and was incorporated in 1964 as American Independence Life Insurance Company. It was renamed and reorganized in 1967 as National States Insurance Company.

The CEO Thomas Green was also the owner of the company. His holdings included banks, real estate, and development companies. His background was much more on the banking side than insurance. The ownership structure is shown below (figure 1):

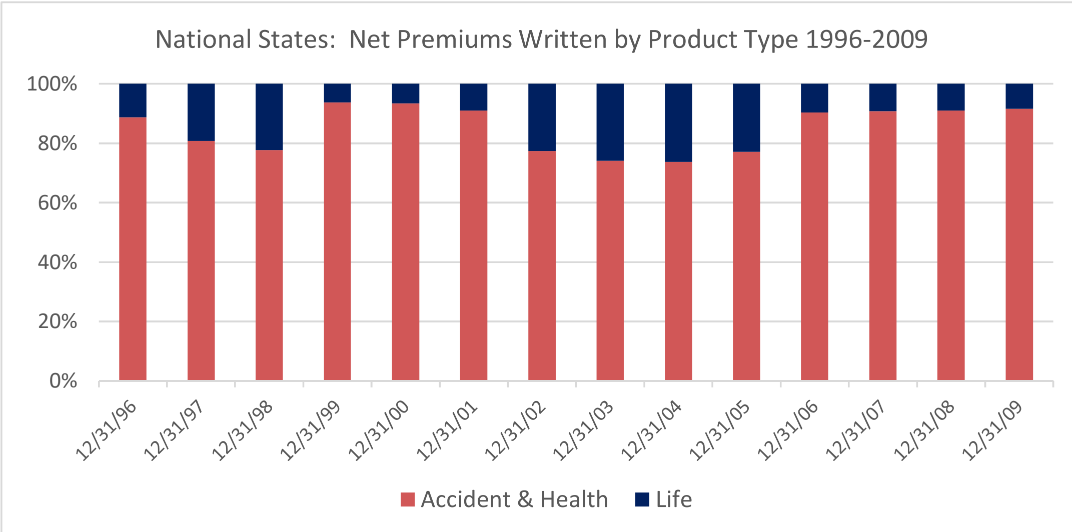
Figure 1
NATIONAL STATES OWNERSHIP CHART



The Company's primary lines of business were accident and health, long-term care, and whole-life insurance. Results, discussed further below, indicated that the LTC business was underpriced for experience that ultimately emerged. Further, the company underestimated the cost associated with the home health care business. By year-end 2006, 90 percent of the business was in health care (figure 2).

Figure 2

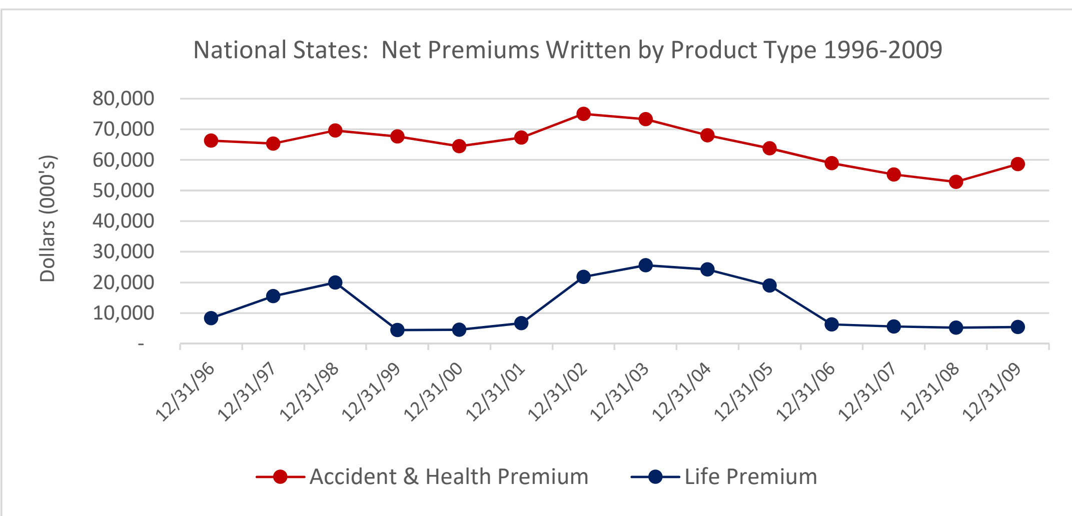
NATIONAL STATES HISTORICAL PRODUCT MIX



Relative to all A&H insurers, National States would be considered small, with a .04 percent market share in 2008 and 2009 based on direct written premium. Net premium growth was steady, and eventually downward, for A&H from year-end 1996 through year-end 2009. Life premiums, which made up a small part of the business, were more volatile over the same period (figure 3). A&H business consisted of guaranteed renewable individual contracts (primarily LTC), and life business consisted of ordinary life.

Figure 3

NATIONAL STATES HISTORICAL PREMIUMS



Net reserves were relatively flat for accident and health (A&H) business from year-end 1996 through year-end 2009. Life reserves increased steadily until year-end 2004. National States entered into a 90 percent co-insurance treaty with Northstar in September of 2005, causing a significant net reserve decrease followed by a gradual increase through 2009 (figure 4). The treaty was in dispute for several years, and was in arbitration at the time of the last examination of National States.

National States' total capital and surplus slowly declined after year-end 1996. By year-end 2008, the decline became more significant. Likewise, the ratio of reserves and deposits to capital and surplus gradually increased, again impacted by the co-insurance treaty in 2005, and continued to increase at a more rapid rate until year-end 2009 (figure 5).

Figure 4

NATIONAL STATES HISTORICAL RESERVES

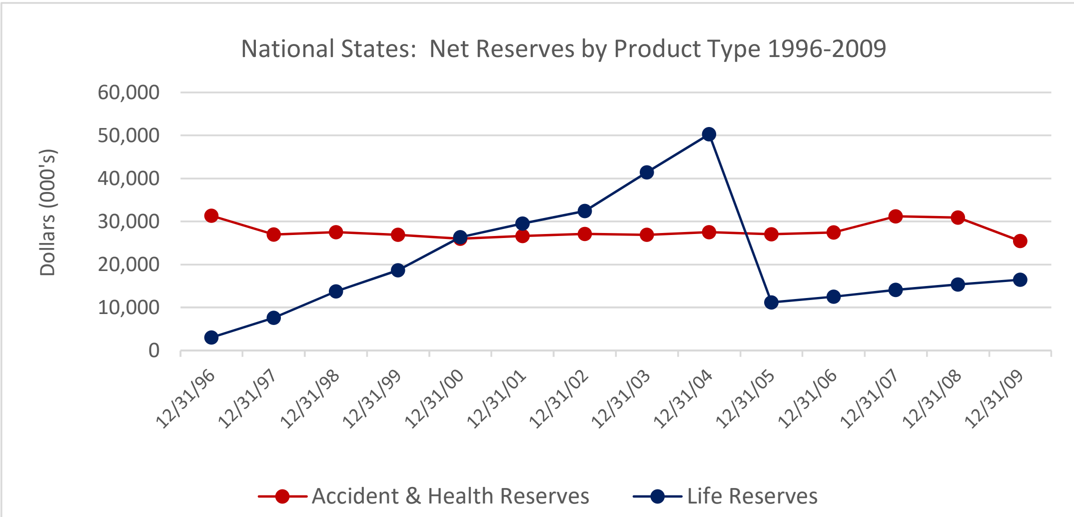


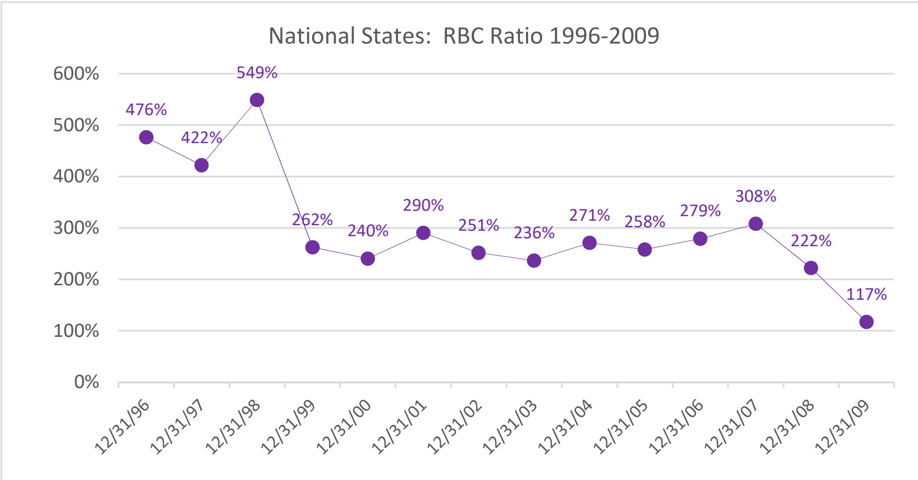
Figure 5

NATIONAL STATES HISTORICAL CAPITAL AND SURPLUS

National States' risk-based capital (RBC) ratio showed periods of decline followed by consistency between the years ending 1999–2007. The decline in 1999 was driven by a significant increase in the Authorized Control Level RBC calculation. After year-end 2007 the decline was more significant (figure 6). The 2006 Notes to Financials include the following regarding their weak risk-based capital position: "Statutory strain associated with the growth of its life insurance and long term care products, adverse experience on the South Florida home health care block, and increased life claims have contributed to the deficits."

Figure 6

NATIONAL STATES HISTORICAL RISK-BASED CAPITAL RATIO

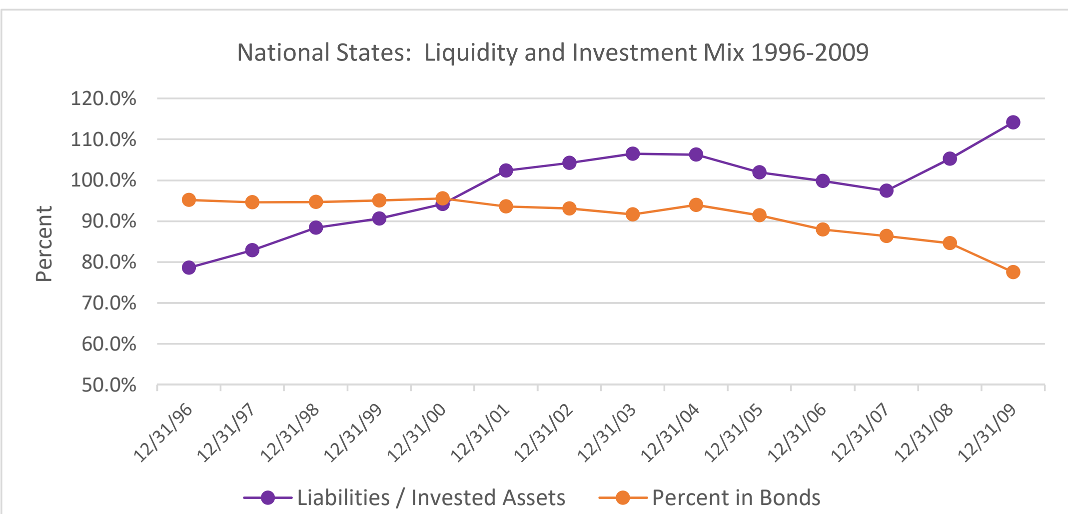


National States' investment in bonds began decreasing after year-end 2004. The decrease was offset by an increase in contract loans. In their last few years of business, the bond investments shifted from predominantly U.S. government bonds to industrial bonds.

The liability to invested assets ratio increased gradually from year-end 1996 to 2003, then had a few years of decline, after which it increased again (figure 7). This is aligned with one of the root causes of National States' ultimate insolvency: poor experience and underpricing on the long-term care business caused reserves to grow faster than assets.

Figure 7

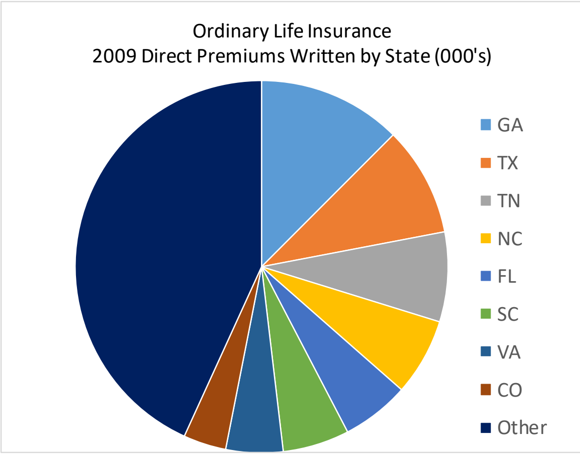
NATIONAL STATES HISTORICAL RESERVE LEVERAGE AND INVESTMENT MIX

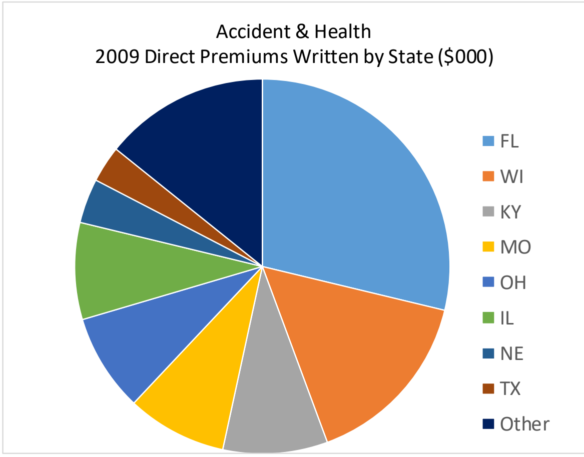


National States wrote Life and A&H premium in various states. Based on 2009 direct written premiums, its largest states were Georgia (12.5 percent) for Life and Florida (29 percent) for A&H (figure 8).

Figure 8

NATIONAL STATES 2009 PREMIUM MIX BY STATE





Florida Business

The largest block of A&H business was written in Florida, and included LTC, home health care, and Medicare supplement. Loss ratios for Florida LTC appeared unfavorable as early as year-end 2006 and continued to increase to a high of 141 percent three years later. Loss ratios in aggregate for LTC were lower due to the offsetting effect of other states' more favorable loss ratios (figure 9).

When it became clear that the LTC business was not performing as expected, National States filed for rate increases in all states, including a 38 percent increase in Florida. Florida denied the rate increases, and National States elected to litigate. National States prevailed initially, but Florida appealed. Ultimately, the appeals court upheld Florida's position. While the rate increases approved by other states improved the Company's outlook slightly, the impact, given the smaller blocks, was not enough for the Company to achieve profitability. If Florida had approved a rate increase, given the larger block of business, it would have positively affected profitability, but it is not certain that that in and of itself would have ultimately guaranteed solvency.

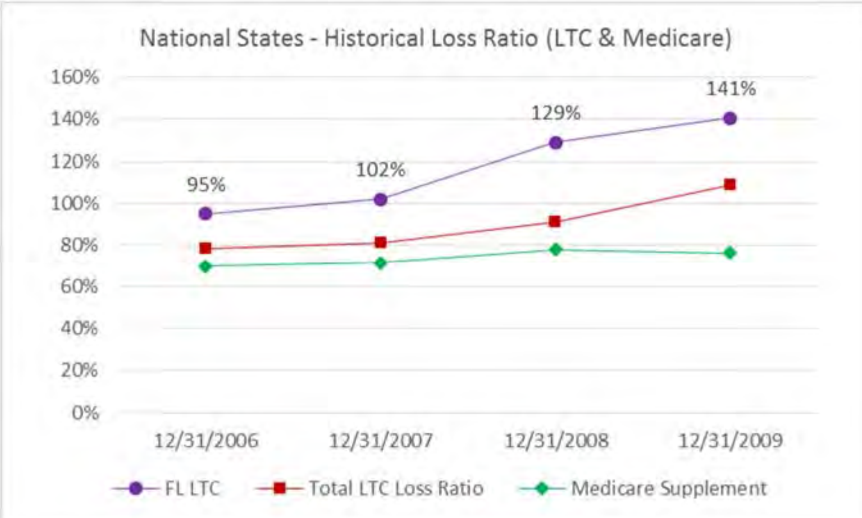
The 2006 Notes to Financials note the following regarding Florida rate issues:

"The Company has received a favorable decision from an Administrative Law Judge (ALJ) in Florida recommending that the Office of Insurance Regulation (OIR) approve a 38% rate increase on the Company's home health care business. The OIR rejected the Judge's recommendation, however, and the Company has appealed the case to district court." In 2007 the court did not uphold the ALJ's recommendation as the Company had expected.

Aside from rate increases, the Company noted corrective actions including increases in reinsurance, discontinuing its graded-benefit life product and stand-alone home health product sales in South Florida.

Figure 9

YEAR-END 2006–2009 LOSS RATIO FOR LTC AND MEDICARE SUPPLEMENT



Florida LTC Environment

By 2003, Florida was the second-largest LTC state based on total premium (figure 10). Given that Florida has the oldest population of any state, one might expect this. Accordingly, Florida regulators focused efforts on LTC oversight to a greater extent than many other states. An August 2005 report by the Florida Office of Insurance Regulation notes the following:

- In 2001, Florida lawmakers added mandatory liability coverage requirements for nursing homes, and implemented tort reforms to cap punitive damages and attorney's fees to make liability insurance more affordable for providers.
- In 2002, the state legislature created a new Office of Long-Term Care Policy in the Department of Elder Affairs to evaluate and improve the state's long-term care delivery systems.
- Florida law currently does not allow insurers to increase premiums due to age or medical conditions, and the marketing materials used by insurers often include statements indicating these limitations.

Figure 10

TOP TEN STATES FOR LTC PREMIUM—2003

Source: Florida Office of Insurance Regulation August 2005 Report "PHASE I: Long-Term Care Insurance" (2003 NAIC Data; LTC Insurance Experience Report C)

Rank	State	Total Premium
# 1	California	$4,354,046,048
# 2	**Florida**	**$4,202,765,436**
# 3	New York	$3,574,481,614
# 4	Illinois	$2,444,742,253
# 5	Pennsylvania	$2,328,228,708
# 6	Ohio	$1,883,867,817
# 7	Texas	$1,845,828,796
# 8	Washington	$1,223,459,099
# 9	Michigan	$1,171,715,545
# 10	Virginia	$1,155,738,145

Based on 2004 market share, National States was the tenth-largest provider of LTC insurance in Florida (figure 11). This represents a 52 percent decrease in enrollment compared to 2000. A few insurers discontinued writing LTC in Florida, adding to the diminishing pool of providers in the state. The Florida market did not present an issue solely for National States; as of the writing of this report, Penn Treaty is in the midst of insolvency proceedings due to the poor performance of its long-term care block, a significant portion of which was based in Florida, and several of the other writers are suffering from long-term care business losses as well.

Figure 11

TOP 10 FLORIDA LTC INSURANCE WRITERS BY MARKET SHARE—2004

Source: Florida Office of Insurance Regulation August 2005 Report "PHASE I: Long-Term Care Insurance"

Rank	Company	2004 Enrollment	2000 Enrollment		Change
# 1	General Electric	52,442	29,371	↑	79 %
# 2	John Hancock Life	42,704	17,137	↑	149 %
# 3	Bankers Life & Casualty	34,875	14,111	↑	147 %
# 4	UNUM Life Insurance Co.	33,470	15,605	↑	114 %
# 5	Conseco Senior Health*	31,276	33,058	↓	5 %
# 6	Penn Treaty Network	27,458	34,636	↓	21 %
# 7	Continental Casualty	27,080	20,649	↑	31%
# 8	Kanawha Insurance	11,119	5,893	↑	89 %
# 9	Fortis Insurance*	10,979	13,102	↓	16 %
# 10	National States Ins.	7,562	15,811	↓	52 %

*These companies have discontinued writing LTC policies in Florida.

LTC insurance already has the challenges of adverse selection, health care cost inflation, and limited risk pooling, and these are magnified in the state of Florida, where the overall age of the population is high. According to a 2010 U.S. Census report, Florida ranked highest among states in the percent of population over the age of 65, at 17.3 percent of the population compared to the U.S. average of 13.0 percent. Further, five of the top 10 highest median age counties in the U.S. are in Florida.

Missouri Department of Insurance

Based on discussions with a former employee of the Missouri Department of Insurance, Financial Institutions, and Professional Registration (DIFP), the researchers understand that the DIFP identified a reserve shortfall for National States prior to its insolvency, and encouraged the Company to increase its reserves. Had this occurred, the Company might have entered rehabilitation earlier than was ultimately the case.

Shortly before the 2010 Rehabilitation Order, the DIFP reviewed an independent actuary's analysis, and concluded that the Company would need a significant amount of additional capital to remain solvent. This led to the Company's Rehabilitation Order in April 2010.

Company Ratings-

The Company's history of rating by agency is shown below:

Figure 12

NATIONAL STATES RATING AGENCY HISTORY (SNL FINANCIAL)

Credit Ratings Details

	S&P	Fitch Ratings	AM Best
Financial Strength	Remove *2/28/2003*	Remove *3/23/2009*	Remove *6/25/2012*
	BBpi Affirm *2/27/2003*	BBq Affirm *6/27/2008*	F Downgrade *3/7/2011*
	BBpi SNL Start *4/11/2000*	BBq Upgrade *7/31/2007*	E *4/7/2010*
	-	Bq Affirm *8/22/2006*	Remove *12/2/2009*
	-	Bq SNL Start *8/15/2005*	C++ (ON) Downgrade *2/27/2009*
	-	-	B- (OS) Affirm *1/18/2008*

Ratings Watch Action Legend: (WP) Watch Positive, (WN) Watch Negative, (WU) Watch Uncertain, (WR) Watch Removed, (OP) Outlook Positive, (ON) Outlook Negative, (OS) Outlook Stable, (OD) Outlook Developing.

In January 2008, A. M. Best revised its outlook for financial strength rating (FSR) from negative to stable. They quoted the following actions: "[I]ncreasing the amount of reinsurance on its life products to offset new business strain on its capital; implementing rate increases on its senior health business; and discounting its graded benefit life products segment. These actions, combined with a lower incurred life and health benefits and a lower number of in-force policies, have resulted in profitable operations over the past two years."

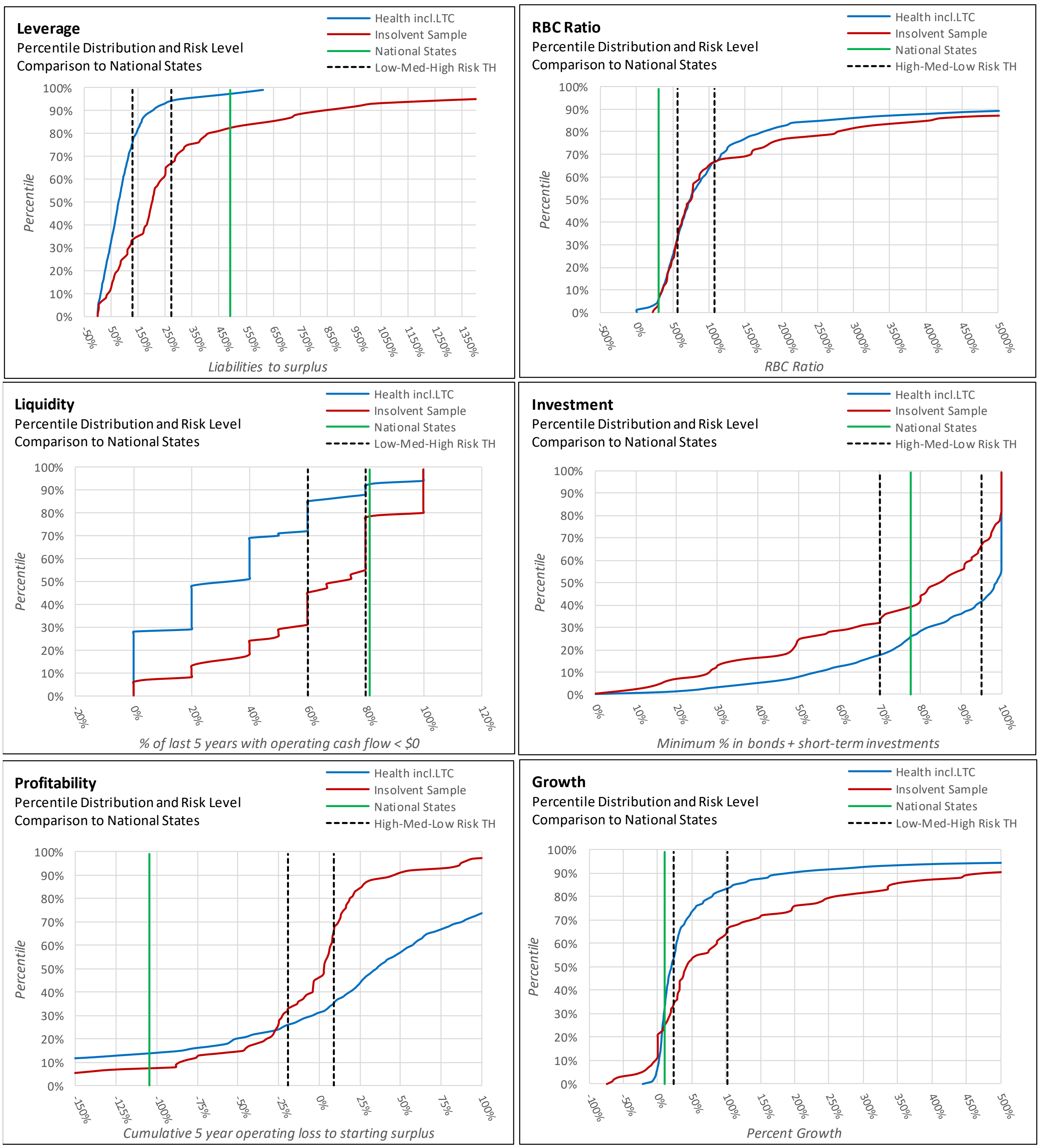
However, A. M. Best further noted that "National States will continue to be challenged in the managing run-off of the South Florida home health care block and trying to grow its Medicare supplement business."

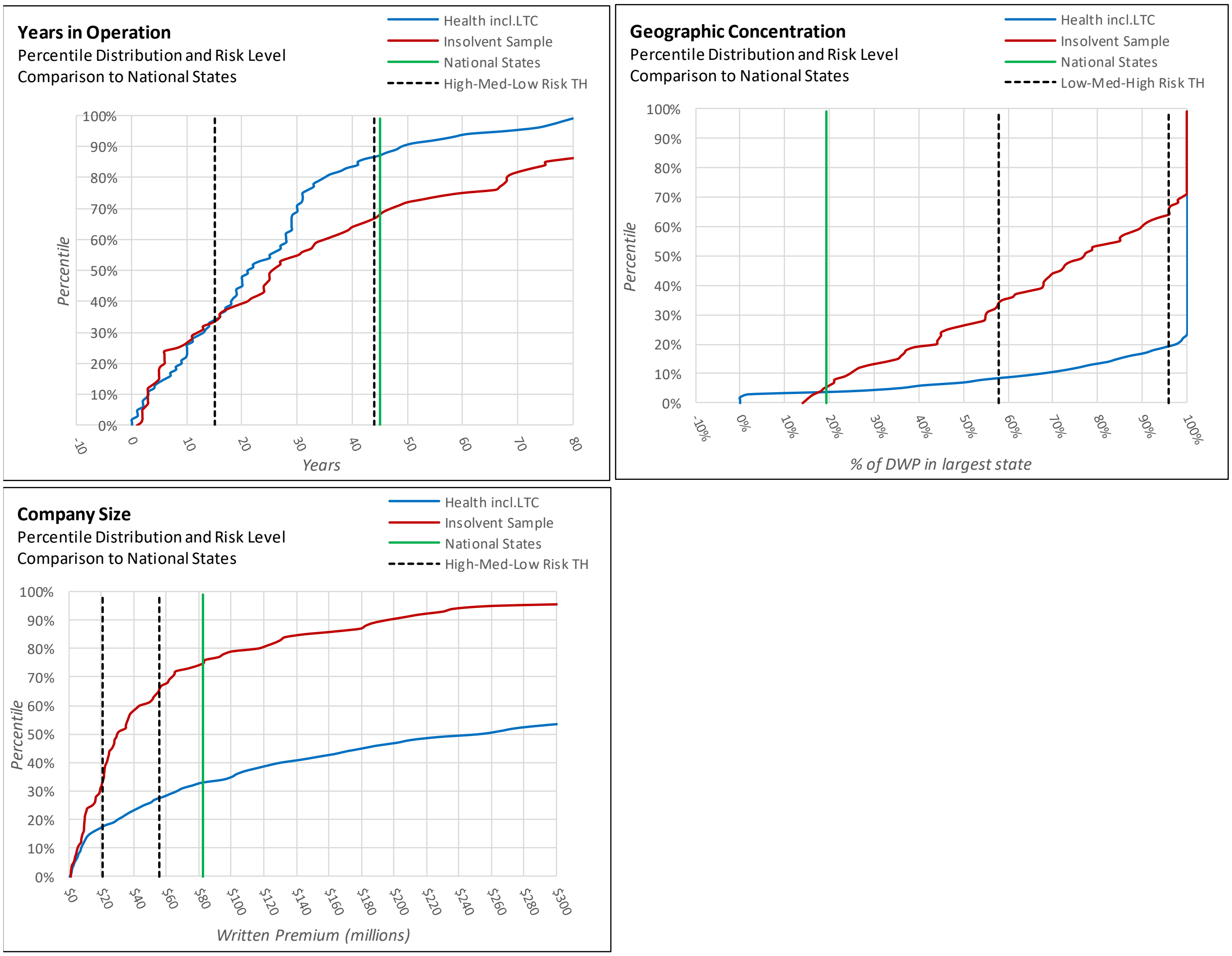
Section II—Phase I Comparison

Based on the data available prior to insolvency, we summarized National States' risk profile and compared it to the analysis performed in Phase I. The following charts include a percentile distribution from the insolvent and health industry samples as well as the risk thresholds ("TH") determined in Phase 1 and the Company data point. Low, medium, and high risk thresholds are denoted by the dotted line. The legend further indicates directional order.

Figure 13

NATIONAL STATES RISK PROFILE AND PHASE I COMPARISON





*National States' metrics based on last five years in operation 2005–2009; industry sample based on 2011–2015; insolvent sample based on last five years in operation by company.

The following is a summary of observations related to figure 13:

- Overall, during Phase 1, the most indicative risk factors for the health cohort appeared to be premium growth, profitability, liquidity, leverage, and RBC ratio.
- When compared to the insolvent sample and the industry sample (health, including LTC cohort) in the charts above, National States ranked higher risk in most financial indicators except growth.
- Leverage, RBC ratio, profitability, and liquidity all fell in the high-risk range for National States, suggesting that these may have been strong leading indicators.
- Investment fell within the medium risk range for National States. This suggests that investment risk may not have been a strong leading indicator to the same extent as leverage, RBC ratio, profitability, and liquidity.
- Contrary to the higher risk factors above, National States' number of years in operation, company size, and geographic concentration puts them in a lower risk range. These factors were found to be weaker than the financial factors in the Phase I research with regard to the insolvency indication in our Phase 1 study. In addition, our measurement of geographic concentration is focused on the overall number of states in which the company writes business, and does not take into account the potential for a substantial portion of business in one particular state where rate increases are challenging.

Section III—Analysis of Key Findings

Some of the key regulatory activities that now exist (or are under development) that may help identify issues such as those that were present in the National States' insolvency are as follows:

a) **Risk-Focused Examination (RFE)—**The movement to a risk-focused examination may help in situations like that of National States. Risk-focused examination became an accreditation standard in 2010. Under a risk-focused examination, the focus is on the overall risk profile, including prospective risk, rather than primarily on the accuracy of the financials. For example, a detailed review of pricing might have identified inadequacies earlier. Further, ensuring the examination actuary is involved in a review of pricing and risk management may facilitate earlier intervention. As previously noted, however, our understanding is that the DIFP did identify reserve issues with the Company prior to its rehabilitation and subsequent liquidation in 2010.

b) **Regulatory Stance on Rate Increases—**In this instance, the Florida insurance department did not approve rate increases, thereby limiting the ability of National States to modify its pricing upon determining that inadequacies existed. According to the opining actuary, the rate increases were actuarially justified, and in the case of the Medicare supplement, an increase in benefits was federally mandated. Regulators are often confronted with competing priorities of this nature; if the priority is to protect the consumer from rate increases, the risk of insurer insolvency increases. Conversely, allowing rate increases may contribute to a decrease in the risk of insurer insolvency at the expense of higher costs to consumers. In addition, the multi-state review of rate adequacy can result in significantly negative financial results in a small number of states. This was addressed in part by the Interstate Insurance Product Regulation Compact ("the Compact"), a multi-state agreement that creates a national public authority to receive, review, and make regulatory decisions on insurance product filings according to national uniform standards that the participating states develop and adopt. The Compact covers individual and group products for life insurance, annuities, disability income, and long-term care insurance. The Compact came into being in March 2004. The compact's governing body, the commission, was created in May 2006, after the required number of states—26, or states representing 40 percent of premium volume nationwide—joined the Compact. While this development has improved uniformity of rate review, not all states are members (for example, Florida is not), and some do not participate with respect to LTC filings.

c) **Reserve Increase Requirements**—Along with the introduction of risk-focused examinations is an increased focus on prospective risk. Regarding reserves for long duration business, there is increased scrutiny of the appointed actuary's assessment of reserve adequacy, and the assumptions regarding future management actions such as rate increases. It is possible that improvements that have been made, and continue to evolve, in this area would have resulted in earlier identification of reserve inadequacy. The actuary's role in this review process is critical, since significant judgment is applied in setting assumptions for assessing reserve adequacy.

d) **Requirements for Corporate Governance**—National States' ownership and management structure may have lent itself to conflicts of interest. The owner, who was president and CEO, also served as the Company's retained attorney. The nine-member board of directors was comprised of four National States executives, plus the owner of National States' largest distributor, a family member, and a chairman who was the CEO of Royal Banks of Missouri, which was owned in part by National States' CEO. Further, the Company wrote business through independent general agents, with the owner of the agency that contributed the largest sales being a director and stockholder of National States. Lastly, the Company's real estate management was provided by a family member-owned business. Stricter oversight on corporate governance may have had an impact on business decisions and thereby changed the course of the road to impairment. Some of the more recent corporate governance standards adopted by the NAIC, for example the annual corporate governance disclosure requirements and the enhancements associated with group supervision (Insurance Holding Company System Regulatory Act and Insurance Holding Company System Model Regulation with Reporting Forms and Instructions), may have helped identify these issues.

e) **NAIC Filing Requirements for LTC on Stand-Alone Basis—**In the aggregate, the LTC deficiencies were being offset by other A&H lines, and as a result, the Company was not required to record a premium deficiency reserve (PDR). This is another area in which increased focus on prospective risk, and increased involvement of actuaries in the examination process, may have helped to identify issues. Evaluation of the PDR, and the grouping of business for purposes of determining the need for one, is commonly reviewed as part of the risk-focused examination process.

f) **Opinion Rate Increase Qualifier—**The final Statement of Actuarial Opinion (SAO) in 2009, signed by the company actuary, included a critique of Florida's actions (rate increase denial). The basis for the opinion included an assumption of a significant rate change in Florida during the following year as a requirement for the continued sufficiency of reserves. Prior SAOs did not make specific mention of the rate increase assumption as a contributing factor to the reserve sufficiency. Based on the subsequent deficiency and wording in the 2009 SAO, an assumed rate increase may have been built in at each historical evaluation. If so, this assumption, at least for Florida, never came to fruition. Perhaps this assumption could have been put to question earlier than 2009. Improvements in actuarial standards of practice (ASOP) since 2009 may have helped address this issue. In particular, ASOP 41, Actuarial Communications, effective for communications issued on or after May 1, 2011 requires that "*the actuary should state the actuarial findings, and identify the methods, procedures, assumptions, and data used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary's work as presented in the actuarial report*." It also requires that, for assumptions not prescribed by law, the actuary either take responsibility for the reasonableness of the assumption or disclose that the assumption is unreasonable (or that reasonability cannot be ascertained).

g) **Changes in Opining Actuary—**At year-end 2000, National States used a third-party actuary to furnish its SAO. Beginning at year-end 2001 and into 2009 (the last full year of operation), the chief actuary prepared an internal SAO. The appointed chief actuary was the former Milliman actuary. For these ten years (and perhaps longer), the same actuary provided the SAO. This potentially suggests consideration of whether periodic changes in the individual providing the SAO may prove beneficial to earlier recognition of potential insolvency risk.

h) **Morbidity Risk in Capital**—Starting in 2005, the NAIC implemented revisions to the RBC formula for LTC business. Prior to 2005, the RBC charges were based on premium only, with factors consistent with those used for disability business. In 2005, a new methodology was introduced with a higher factor on premiums, along with a factor based on claims and loss ratio levels. This improvement would have largely increased industry pricing of the business, though pricing changes made by National States at that time may have come too late. The formula still does not fully capture the combined impact of morbidity, interest rate, and longevity risk for long-term care products.

i) **Follow-up to Examinations—**Issues with company operations were highlighted as early as 2003.

- <u>2007 Financial Examination</u>
    - There is a comment from the prior examination (2004) that RBC in the 2004 Annual Statement was overstated due to misclassification of FL home health care policies.
    - There is a subsequent event in the 2007 report on losses taken by the company in 2008, primarily on FL home health care LTC business, resulting in a $4.2 million decrease in surplus.
    - National States notes in a letter to the MO DOI that it does not believe it needs a premium deficiency reserve. "The gross premium valuations indicated the shortfall associated with Florida Home Health Care business is offset by sufficiencies in the other A&H lines."

- <u>2003 Market Conduct Examination</u>—Florida Office of Insurance Regulation conducted a market conduct exam dated December 1, 2003, and cited multiple violations (listed below). A subsequent review of the actions taken in response to these allegations was not found.

    - Failed to ensure that its agents did not misrepresent the benefits, advantages, conditions or terms of any insurance policy;
    - Failed to ensure that agents did not make representation on behalf of insureds on insurance applications;
    - Failed to record cancellations accurately and promptly return unearned premium;
    - Collected excess premiums;

- Made material misrepresentations with the intent of effecting settlement on less-favorable terms.

It is unclear whether the examination involved a review of rating practices. If an actuarial review of rating practices were undertaken, either as part of the market conduct examination or as part of the financial examination (though admittedly the financial examinations did not use a risk-focused approach at the time), such review may have uncovered the pricing issues sooner.

In summary, it appears that the key drivers of National States' insolvency were the concentration in long-term care business, inadequate pricing of the business, and inability to achieve rate increases, potentially compounded by a relatively weak corporate governance structure.

There are some key areas related to the issues at National States in which increased actuarial involvement may have supported earlier identification of some of these challenges:

- Increased involvement of actuaries in the surveillance process. Some of the key issues, such as the underpricing and the aggressive rate increase assumptions used in the reserve adequacy analysis, would likely be identified and evaluated by an actuary in today's risk-focused surveillance process, which did not exist at the time of the insolvency.
- Improved practices and disclosures regarding the assumptions used in assessing reserve adequacy. Since the issues occurred at National States, we have had several enhancements in ASOPs, including ASOP 41, as well as additional guidance for actuaries through educational materials, such as a revised practice note regarding asset adequacy analysis practices.
- Increased coordination and consistency of actuarial requirements across states. This has been addressed in part through the creation of the Interstate Compact, and further activity is underway through the Senior Issues Task Force and the Long-Term Care Valuation Subgroup, including items such as:
    - Additional disclosures to consumers;
    - Additional requirements for rate filings;
    - Experience tracking;
    - Additional requirements for testing adequacy of LTC reserves.