Reinsurance Section News

March 2003 – Issue 51

Long-Term Care Reinsurance:
The Need Continues; The Need Changes

by Gary L. Corliss

Reinsurance for long-term-care insurance has been around since the mid 1980s. At that time, the number of insurers and the number of reinsurers was small. By the early 1990s, the number of insurers had grown to about 150. An article in the "Reinsurance News" of the SOA in September 1991 reported that 15 reinsurers revealed that they were in the LTC reinsurance business. As of July 2002, three reinsurers had almost 100 percent of the reinsurance market in the United States. Doesn't that sound familiar? The primary writers of LTC insurance in the United States. have been reduced from 150 down to about 120. Within this group of 120 primary writers, almost 90 percent of the total production of LTC premium is coming from the top 20 organizations. This has created a large concentration of expertise, knowledge and data in a small number of insurance organizations. How can the large number of smaller insurers or any new entrants compete effectively and competitively when they are at such a disadvantage in expertise, knowledge and data? The answer is LTC reinsurance.

Reinsurance was created centuries ago to reduce concentration of risk. Secondarily it has more recently become known as conduit or access to expertise, knowledge and data. Obviously, the need is there for LTC reinsurance and reinsurance services. So what are the types of reinsurance and reinsurance-related services available for LTC insurers and how do these apply to the needs of today's business environment?

Types Of Reinsurance

Although many reinsurance arrangements are possible, four types that are commonly used. These four types may be used singularly or in combination with each other.

Proportional quota-share (PQS) is the most widely offered form of LTC reinsurance. In this arrangement, the insurer and reinsurer share in all the risks of the product. This includes all the morbidity, mortality, persistency, investment and expense risks. A reinsurer also shares in risks that may arise after issue, including the impact of mandated benefits and state regulation on the profitability of the reinsured policy forms. The extent of the risk sharing is proportional to the percentage of the reinsurance ceded. For example, in a 60/40 relationship, the insurer retains 60 percent of the risk and cedes 40 percent of the risk, from the first dollar expended.

PQS reinsurance serves an insurance company best when there is uncertainty of events or a real possibility of deviation in results, particularly of an unknown or not easily quantifiable magnitude.

There is uncertainty when innovative product features or benefits are being offered to the public by either large, small or new companies in the market. LTCI is still in its infancy. This suggests that there should be new benefit designs coming to market regularly that can benefit from reinsurance.

In the early days of LTC insurance and reinsurance, PQS reinsurance was considered an aid in supporting growth of the writing company by providing expense dollars to write new business due to the initial surplus strain. More recently, in addition to the initial surplus strain, it has been recognized that the high persistency under LTCI also requires additional investment after the first policy year as the build up of significant active life reserves necessitates a commitment of further capital due to

continued on page 30

risk-based capital requirements. Now there are two strong reasons to use PQS reinsurance to support growth.

Also in the early days of LTCI, there was concern because LTCI was a lapse-supported product. Should expected lapses fail to occur, larger reserves would be required and larger future claims would be greater than originally assumed. History has shown us that lower voluntary lapses did occur. Current pricing is reacting by using more appropriate and lower lapse rates thus leaving the product with much less risk and sensitivity due to deviations in voluntary lapse. However, there has been an improvement in the mortality rates from those originally used such as the 1983 GAM mortality table. Recent publications and tables are suggesting that it could improve further. This causes concern of this lapse-supported product to sway away from the voluntary lapse rates toward the involuntary mortality rate.

Early LTCI policies (1980s) were priced expecting that invested funds could yield as much as 9 percent annually. We have seen that expectation steadily change downward to the 6 percent range with some individuals suggesting that a "safe" yield rate may be more in the area of 4 percent. PQS protects a ceding company from this result.

Recently there have been several legal situations involving LTCI. The net result of these cases has restricted the writing company from unlimited rate increases. The protection and comfort that a writing company may feel due to the guaranteed renewable language of their policy has been weakened by the outcome of these situations. PQS provides protection under these types of originally unanticipated actions.

Regulatory changes are impacting future premium changes in other ways. Rate stability regulation places caps on the size of rate increase that a writing company may be able to achieve. Again, the PQS reinsurer shares in this result.

Proportional claim-only (PCO) reinsurance protects the insurer from adverse experience due to the morbidity risk only. This protects the insurer from the risks of higher claim frequency and longer claim duration than expected in pricing. As with proportional quota-share, the extent of the risk sharing is relative to the reinsurance percentage. While PCO reinsurance provides much less protection and does not cover many of the risks mentioned above for PQS, it can provide important protection for an insurer who is concerned about claim variability.

This is probably a better approach for smaller rather than very large writers of LTCI because the smaller writer has more of a chance of variability in results due to less exposure.

PCO will help protect against early claims that are greater than anticipated in pricing from the select and ultimate factors.

It can help a company that is concerned about anti-selection in the early years if it has an inexperienced underwriting staff that may miss some important information and issue some policies that it should have avoided.

PCO will help protect against early claims that are greater than anticipated in pricing from the select and ultimate factors.

It can also help a company that has an inexperienced claim organization or one that is new to the business. A claim department that has few policies in force likely does not have sufficient expertise due to handling few claims and thus may accept some claims inappropriately while its learning curve is being ascended.

An inexperienced claim staff may not have enough knowledge and ability to limit claims to their appropriate levels, thus causing longer and larger benefit payments than necessary.

*Excess-of-loss reinsuranc*e (EOL) is a subset of proportional claims-only reinsurance. This protects the insurer from large claims. A large claim may be defined in terms of a long benefit period or it may apply to a large benefit amount. For example, an insurer may want to avoid all claims payable after the expiry of both the waiting period and two years worth of benefit days or after $50,000 of benefit payments have been incurred. With this form of reinsurance an insurer is unconcerned with the number or frequency of claims that occur but is concerned with the length of claims they receive.

EOL reinsurance may help a company with inexperienced underwriters who are not successful in avoiding long claims such as those derived from individuals with Alzheimer's, senility, dementia, central nervous system disorders or mental and nervous disorders.

This reinsurance may also help a company that has claim staff inexperienced in handling, coordinating and limiting claims whether they should be of a short nature or of the lengthy type as mentioned above.

There is some indication that at least with older issues, the underwriting may be too good! This is being played out in an adverse consequence. Some applicants who are insured at ages above 80 may have longer incurred claims than expected because they are so healthy from a mortality perspective. EOL reinsurance may minimize the negative financial impact.

Portfolio aggregate stop-loss (ASL) reinsurance provides potentially high reimbursement with a low probability of collection. Under this arrangement, the insurer's incurred claims are evaluated on a calendar year basis. This reinsurance pays when the total paid claims (whether large or small in nature) from a particular policy form or forms (ie. portfolio) for a specific covered calendar year exceed a specific amount. The stop-loss point is typically a percentage of expected claims. For example, if incurred claims for a calendar year exceed 150 percent of those anticipated, the reinsurer pays all the benefits becoming payable after the 150 percent point (often referred to as the attachment point).

ASL reinsurance arrangement is suited for those companies with a more-than-adequate surplus to cover both the original expenses and the risk-based-capital requirements, but is concerned with large deviations in claim results for specific calendar or financial reporting years. This form of coverage is more appropriate either alone or in combination with other forms of reinsurance for those companies that have a large exposure of in-force business.

Types of Services

The section above described the types of reinsurance that are available from reinsurers. Other than surplus relief, these reinsurance forms may be considered as devices to "pass off a share of the bad results." They are ways to lessen the adverse financial results from generally unanticipated circumstances or deviations from pricing assumptions. That can be considered a negative approach to using reinsurers.

That is not the only way a reinsurer can help. There are positive ways to work with a reinsurer to secure better results for the ceding company on its portion of the business retained.

Under a special form of PQS called modified coinsurance, the reinsurer may be able to increase investment yield for the writing company by investing the writing company's LTCI funds.

A well-staffed reinsurer can improve a ceding company's daily operation through a business evaluation that audits, examines and analyzes a company's internal structure and operation through an extensive evaluation of financial controls, reserve adequacy, underwriting and claim guidelines and processes. With the developments in the business community over the past year, management must take extra steps to ensure that operations are functioning as cleanly as possible.

Overall risk management review takes the Business Evaluation one step further by reviewing not only the daily operations but also by examining how an LTC insurer is addressing all of the risk elements within the product and within its organization in total.

Lastly, an insurer may be able to benefit from a reinsurer who can actually perform many of the risk related services such as contract drafting, underwriting and claim adjudication. The reinsurer should be current with the latest of best practices in each of these areas and may be able to perform them with better results both on the reinsured and the retained business.

Summary

The LTCI marketplace has been changing over the last 20 years. The LTCI products being offered have changed. The number and size of the insurers and reinsurers has changed. Knowledge of the business has grown. The reasons that a writing company may believe it needs or wants reinsurance have changed. The four major types of reinsurance, especially proportional quota-share, have provided valuable protection in ways that the original purchasers of reinsurance did not anticipate. While the reasons to reinsure have changed, the need continues. ✍

Gary L. Corliss is CEO of Avon Long Term Care Leaders located in Avon, Conn. He can be reached at gcorliss@avonltcl.com.