SOCIETY OF ACTUARIES

November 2003, Issue No. 21

Small Talk

Newsletter of the Smaller Insurance Company

Published in Schaumburg, IL by the Society of Actuaries

From the High Chair

by Susan M. Reitz

I am a mother of four children ranging in age from two to sixteen years. The one aspect of parenting that continues to amaze me is the incredible number of different hats that I have to juggle every single day. One minute I'm consulting on a project requiring the use of a miniature pumpkin and a shoebox with the goal of producing a tiny float with a safari theme. The next minute I'm on the phone selling magazines for a school fundraiser. A few minutes later, I'm trying to give a bath to a toddler who loves to splash but hates to wear ear plugs.

There's always a lot to do and not enough time to do it in. You learn to prioritize. Soccer games are more important than clean kitchen floors. You also learn to be efficient. You can clean the bathroom and give the third grader a spelling test while the toddler drives boats in the tub.

This last weekend, in addition to everything else I was doing, I was trying to mull over what I would say in this article. I was struck by the similarities between my life as a parent and my life as small insurance company actuary.

Small company actuaries wear a lot of hats and they need to perform a mind boggling array of duties with limited resources. There's always a lot to do and not enough time to do it in. You learn to prioritize. You also learn to be efficient. While the general issues that we face are the same as those faced by actuaries industry-wide, we do have our own special concerns.

Over the past year, the Smaller Insurance Company Section Council has attempted to address the special concerns of our members. We have sponsored and co-sponsored a number of different sessions at the Spring and Annual meetings, covering topics we felt would benefit our members. We held an interactive forum at the Valuation Actuary Symposium. This has become an annual event, allowing participants a chance to hear what other smaller insurance company actuaries have to say on a variety of current issues. We are also planning a web cast for next spring, tentatively titled, "How to do Asset Adequacy Analysis." Upon discovering that a significant minority of our section members list their primary area of practice as health, we sent out a survey in an attempt to learn what issues were of concern to these members. Finally, we are looking for the correct balance between using blast emails and this newsletter, *small talk*, as methods for distributing timely versus comprehensive information to the section.

One of the keys to an effective section is the interaction between the section council and section members. The Smaller Insurance Company Section Council works hard to identify emerging issues that we feel need to be addressed. I urge any section member, with ideas on topics we should be considering or issues we should be addressing, to contact any of the council members.

I am happy to announce the three new members of the section council: Don Hagen of Shelter Insurance Companies, Terry Long of Lewis and Ellis, and Phil Velazquez of General Cologne Re. I believe the council, and therefore, the section, will benefit from their fresh perspective. Incoming council chairperson, Pete Hitchcock, has a great group of people to work with over the next year.

I would also like to thank retiring council members, John Gately and Jim Van Elsen, for their work on the council over the last three years.

This is also my last year on the council. The last three years have gone by in a flash. I've enjoyed the experience, I've met a lot of wonderful people and I've learned a lot. Hopefully, I've also contributed, in some small way, to making the juggling task of my fellow small insurance company actuaries a little easier. ●

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Editorial

Smaller Copmanies and marketing Innnovation

by James R. Thompson

Introduction: Over the past several years, in reading general literature of our industry, particularly the National Underwriter, I have noted there have been several interesting marketing developments:direct marketing, including telemarketing and direct mail, insurance sales through banks and brokerage houses, worksite marketing and rapid underwriting and issue technologies. Some companies are actively trying new approaches to increase sales and cut costs.

Although we like to view smaller companies as being in the position to adopt new approaches and make changes quickly, a lot of the support for the above developments has been from larger companies or groups. We need to pay attention to developments to see if we can reposition ourselves advantageously. Some of the newer underwriting tools which save money and decrease turnaround time seem attractive.

For those companies, considering more effective ways to sell in the middle market, there is an interesting book published by Actex, which serves as an introduction and which explains some of the mathematics of the improved productivity. This is "Insurance Coverage for ALL!...,"by Maria Thomson, FSA, MAAA (*mthomson@tmsolutionsinc.com*). She wrote an article a year and a half ago for *Small Talk* , outlining some of the material which went into this book, which was just published this year.

Book:

I shall review this book in sequential order of the seven chapters. Chapter One, Overview, deals with the obvious observation that many insurers are chasing the affluent. This has resulted in a lesser percentage of the public covered and higher face amounts. Higher face amounts are generally sold to the more affluent and they require more underwriting. This is expensive and often results in very slow underwriting and issue time, about six weeks on average. A consequence is about a 20% fallout (not getting issued due to not taken and declines or incompletes). Chapter Two, Feeling the Heat, gives some historical perspective on the decline in both life and health insurance among the middle and lower income populations.

Chapter Three, New Ways of Pushing the Product, should be something members of the nontraditional marketing section are quite familiar with. This chapter discusses the broad gamut of telemarketing, newspaper ads, group sponsorships, Internet, workplace and sharing customers with non-insurance companies (that is, cross selling from, say, a banks customer list). The underlying rationale seems to be the attempt to get into the middle income market without the high distribution costs of an agent selling.

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On the cover

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Small Talk
Issue Number 21• November 2003

Published by the Smaller Insurance Company of the Society of Actuaries
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Schaumburg, IL 60173-2226

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This newsletter is free to section members. A subscription is $15.00 for nonmembers. Current-year issues are available from the Communications Department. Back issues of section newsletters have been placed in the SOA library and on the SOA Web site: (*www.soa.org*). Photocopies of back issues may be requested for a nominal fee.

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Printed in the United States of America.

Federal Regulation of Insurance?

by Mark C. Rowley

Senator Hollings (D-S.C.) recently introduced the Insurance Consumer Protection Act of 2003. This act would make the Federal Insurance Commission the only regulator for interstate insurers. The Commission would be responsible for:

- Licensing and Standards for the Insurance Industry
- Regulation of Rates and Policies
- Annual Examinations and Solvency Review
- Investigation of Market Conduct
- Establishment of Accounting Standards

The industry is not supportive of Senator Hollings' bill, and the bill is not expected to be enacted in the near future. So why should we care?

The reason is that discussion on this federal charter has been increasing over the last several years. While this bill may not go anywhere, other efforts may bear more fruit in the future. This discussion is only going on because there is a perceived need for reform in the current state-based regulatory system.

On the positive side, a federal system could eliminate the need to deal with onerous rules that have been adopted by certain states. It would eliminate the need to track state variations in laws; presumably, there would be only one set of rules. On the negative side, the one set of rules might represent poor regulation; if this set is difficult to deal with, the industry might pine for the "good old days" of state regulation. Also, a federal system could lead to dual regulation, if the federal regulations overlay the state regulations —this may be the worst case scenario!

It is also possible that this could be very bad news for small companies. Variable products are federally regulated already due to SEC requirements; the result has been that it is expensive for small companies to do this on their own. In the extreme, small companies could go the way of state chartered banks. This could be a problem with Senator Hollings' bill since it doesn't give companies the option to remain state-regulated. Small companies should consider getting involved in this discussion soon.

A critical issue in any federal system is scope. If all regulatory functions are handled on a federal basis, one result is obtained. However, if the federal system is more limited, a very different result could occur. For example, if the federal system was focused on coming up with a uniform (probably GAAP) accounting basis, but left other regulatory functions to the states, the impact on all companies (small and large) might be similar.

We can look forward to watching this develop over the next several years.

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Chapter Four deals with Rapid Assessment and Delivery (RAD), that is, quick turnaround time. Traditional underwriting uses an (APS) Attending Physician Statement. This seems to be the major cause of the underwriting slowdown. This chapter discusses alternative underwriting data sources that can be rapidly accessed. The author points out that quick turnaround leads to less handling, and thus cheaper costs, as well as reduced fallout rates.

Chapter Five, Product Construction-Simply, contains an analysis of not only the life market but also disability income and medical markets. It also provides a demonstration of how reduced acquisition costs (due to modified underwriting and instant issue) can offset a higher mortality cost that may result.

The final two chapters deal with evolving selling patterns, customer relations management and the bank market. The author has examined this market in Great Britain and seen that it is more sophisticated than that in the United States. This does not bode well for smaller companies because it may mean that the United States bank market will figure out ways to improve. Since the larger banks deal with larger life companies, this might adversely affect the smaller ones. But in the future, perhaps, regional banks will merge with smaller insurers.

Of course, if the smaller companies get on the ball with improving underwriting practices, they may carve out enough market share to survive. Perhaps regional banks will prefer dealing with the smaller companies. They traditionally have greater initiative for making changes. If your company decides to investigate these changes, this book provides a basic background.

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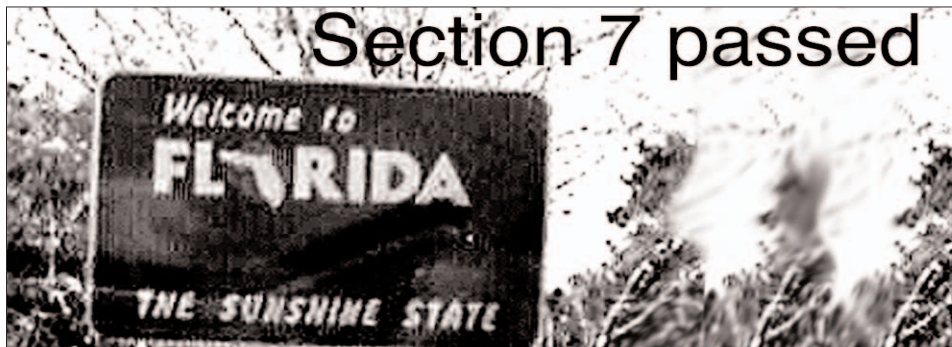
Section 7 Update

by Mark C. Rowley



Last November, I wrote an article for *Small Talk* describing why Section 7 opinions were on their way out. The reason given was that the new Actuarial Opinion and Memorandum (AOMR) regulation had been passed by the National Association of Insurance Commissioners (NAIC) and that it was expected to pass in many states in 2003 and 2004. As it turns out this was a poor forecast since as I write this only the Florida Department of Financial Services has passed the regulation. Much of this is due to the AOMR receiving low priority by busy state insurance departments. However, some of it is also due to state insurance departments (and the industry) being dissatisfied by the alternate actuarial opinions proposed. Note that Florida's version excluded the alternate opinions. These alternate opinions were designed to assist appointed actuaries in dealing with state variations in valuation laws.

For all practical purposes, it appears that Section 7 opinions have gone for companies licensed in Florida.

At first glance, it might appear that the only thing to report along the lines of Section 7 is that nothing much has happened. Only one state has passed the regulation, which can't possibly have much of an impact, right? On the contrary, what it means is that every company licensed to do business in the state of Florida must do a Section 8 opinion for year-end 2003 and annually, thereafter. Florida passed the law effective for all valuation dates after Jan. 23, 2003. Kerry Krantz, Valuation Actuary for Florida, confirmed my understanding of this in a recent e-mail. Also, Kerry recently made the following information available on the SOA general interest web board, for anyone interested in reading Florida's regulation.

`Florida Administrative Code rule 4-138, part III, is available on the internet at http://fac.dos.state.fl.us/. Click Chapter 4—DEPARTMENT OF INSURANCE http://fac.dos.state.fl.us/faconline/chapter04.pdf. Then click D4-138.040 to get to the beginning of PART III ACTUARIAL OPINION AND MEMORANDUM.`

According to Kerry, the "Scope" section of the regulation (4-138.041), paragraphs one and two, makes it clear that the regulation is effective for 12/31/03 valuations.

For all practical purposes, it appears that Section 7 opinions have gone for companies licensed in Florida. While a Section 7 opinion could be filed in other states, it probably makes sense to file a Section 8 opinion everywhere, as long as the work is being done. There are RBC (C-3 factors) and potentially rating agency advantages to filing a Section 8. Of course it also means that companies need to determine quickly what resources are available to do the asset adequacy analysis (usually cash flow testing) required as part of Section 8 opinions. It is also important to keep in mind that efforts prior to year-end reduce the effort needed in January and February.

So are non-Florida small companies off the hook? Perhaps they are, for now. But there are other ways regulators can require Section 8 opinions other than the new AOMR. For several years, companies using X-factors as part of their compliance with XXX have been required to do a Section 8. Also, if you read the fine print of the 2001 CSO regulation, you will find that Section 8 opinions (asset adequacy analysis) are required for any company that values any of their business using the new mortality table. This will impact many companies for year-end 2004. For some companies, asset adequacy analysis will be so expensive it may be worth doing all the things necessary (no business in Florida, no X-factors, and no 2001 CSO) to avoid it. This may work for a small number of companies. 2001 CSO is just a minimum valuation standard, so if 1980 CSO produces higher reserves, it can still be used. However, this will be difficult, since products will become uncompetitive. In the long run, since the 2001 CSO will become the tax table, these products would need 1980 CSO reserves & cash values and 2001 CSO tax reserves and guideline premiums.

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2001 CSO and The Small Company — More Effort Than You Might Think

by Mike Taht

R590-223-2. Purpose. The purpose of this rule is to recognize, permit and prescribe the use of the 2001 Commissioners Standard Ordinary (CSO) Mortality Table in accordance with Sections 31A-17-504, 31A-22-408 and R590-198-5.

The 2001 CSO mortality table was adopted by the National Association of Insurance Commissioners (NAIC) in December 2002. As of August 2003, three states (Texas, Oklahoma and Utah) had adopted the table, and a number of other states plan on adopting by January 1, 2004. 2001 CSO will have a significant impact on life insurance, affecting not only statutory reserves and non-forfeiture values, but also tax reserves, Section 7702 guideline premiums and universal life cost of insurance rates. However, there is one element of the table that may have a greater impact on small companies than large companies. This article touches on this specific issue.

One of the requirements that must be met to utilize the 2001 CSO table is that an asset adequacy opinion must be filed. This requirement was put into the regulation introducing the table to address certain concerns that regulators have regarding use of the 2001 CSO mortality table for statutory reserves. Specifically, regulators were concerned that the table was based on fully underwritten standard ordinary individual life insurance experience only, but that it could be utilized to set statutory reserves for business that was issued utilizing underwriting that was more lenient than full underwriting. The two examples raised, most often by regulators, were simplified issue and guaranteed issue life insurance products. Many small life insurers have significant portfolios of simplified issue or guaranteed issue life insurance (e.g., pre-need life insurance or funeral products).

Often, small life insurers in these markets have not been required to conduct asset adequacy analysis given their size. Even with AOMR (see Mark Rowley's article on "Impact of AOMR"), some of these companies may not be required to conduct asset adequacy analysis. The requirement to conduct asset adequacy analysis raises two primary concerns for small life insurers:

- What kind of model is the organization going to need to conduct asset adequacy analysis?

- Will moderately adverse mortality assumptions (used in asset adequacy analysis) be significantly worse than 2001 CSO and lead to additional reserves that are not tax deductible?

To date, there is not a clear answer to these issues. ASOP No. 22 references a number of different types of analyses that can be utilized to satisfy asset adequacy analysis. The choice of analysis must be appropriate to support the asset adequacy opinion. With respect to mortality being greater than 2001 CSO for some lines of business, this is not a new issue. In today's environment, there are some lines of business with expected mortality even greater than 1980 CSO. Two regulatory solutions that have been suggested during discussions of this issue are the creation of a simplified issue mortality table, and treating the simplified issue/guaranteed issue business as substandard. These solutions face challenges and little work has been done to date to make these suggestions a feasible solution to the issue.

For companies in this position, there are currently two primary methods to address the issue today:

- Do nothing: Although 2001 CSO has been adopted in a few states, a company does not have to utilize 2001 CSO for statutory purposes until 2009. In the interim, perhaps a feasible solution will be put forth by the industry.

- Develop asset adequacy models: Develop reasonable asset adequacy models to see if moving to 2001 CSO results in additional reserves due to asset adequacy test ing. It should be noted that persistency and realistic interest rates are also utilized in asset adequacy testing, and could some what off set the impact of higher than 2001 CSO mortality. Although additional reserves may be necessary, the benefit of a reduction in basic reserves due to 2001 CSO may outweigh the cost of additional asset adequacy reserves.

In the end, this is a key issue that small companies should consider when determining whether or not they should utilize 2001 CSO for statutory reserves.●

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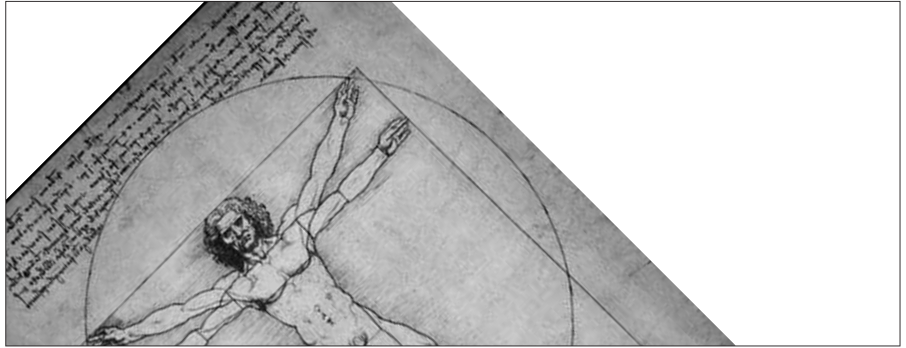
The Future of Health Actuaries

by Kara CLark



What do you want to be doing in five or ten years? Some people have tired of hearing and answering that question, but it's a critical one to ask as we consider the professional outlook for health actuaries. To that end, the members of the SOA's Health Benefit Systems Practice Advancement Committee and Health Section Council have recently been exchanging thoughts around a series of questions related to the roles health actuaries should be able to assume in the future. A summary of that discussion follows.

Health actuaries should be able to maintain a position in more traditional roles, including plan and product design, pricing, valuation and financial management for insurance companies, managed care organizations and employee benefit plans. We should also be able and looking to expand our position into areas of management and strategy, including long range planning and modeling.

Integrating our expertise with those from clinical backgrounds will be critical in expanding our roles to include data mining and analysis to understand patterns of care and to demonstrate how and why health care is delivered differently in different areas and under various circumstances. Health actuaries cannot and should not replace the professional judgment of those actually providing healthcare, but we can provide an understanding of how financial issues and risk (including risk related to access and quality) are impacted by treatment patterns. We can work alongside other professionals in designing reimbursement programs that appropriately complement medical management processess, and therefore, serve to benefit a collective group of stakeholders.

—moving from the more traditional "payer" or "sponsor" side to include providers, patients, research organizations and communities as well.

Health actuaries should also be looking to assume a greater role, not only in the technical aspect of risk measurement, but also as business managers and advisors in the areas of risk identification, evaluation and management. Our approach needs to become more proactive and our viewpoint more holistic, so we can add value to our clients, not only through our skills in risk management and mitigation, but also in risk capitalization. There are opportunities for us under the umbrella of enterprise risk management, including roles as chief risk officers.

We should also be able to expand our roles in many of these areas relative to the clients we serve—moving from the more traditional "payer" or "sponsor" side to include providers, patients, research organizations and communities, as well. Our ability to translate risk theories into practical applications should also position us to be able to assume a greater strategic role in the policy community, by working with other disciplines to develop policy rather than limiting ourselves to evaluating the policy proposals others have defined. We can also play a role in evaluating the long-term implications of "environmental influences" and in modeling the uncertain impact of these influences on our society and its economy.

To create these roles, we will need to consider potential partners as well as our competition, how we want to position actuaries in the marketplace and what specific tactics we need to undertake to move us in the right direction. Your perspective on any of these issues is valuable and we encourage you to share it via a Health Section listserve, with a member of the Health Section Council or Health Benefit Systems Practice Advancement Committee (rosters can be found on the SOA Web site), or with Kara Clark, SOA health staff fellow. ●

Kara Clark FSA, MAAA is the SOA health staff fellow and she can be reached at 847.706.3576 or at kclark@soa.org

Deferred Annuities: A Tiger by the Tail

by James R. Thompson

Intoduction: Many smaller life companies sell a mixture of permanent life and fixed annuity policies. Some are trying to sell life insurance but have kept a traditional annuity around and not paid that much attention to the pricing. Suddenly in the past year, money is pouring in, almost without asking for it. Was it considered an unexpected bit of good news? The reason lies in the other market places. The past two years have seen some surprising shocks by the Federal Reserve, which lowered interest rates to levels not seen for decades. The high returns in the stock market a few years ago have been replaced with lowered stock prices as well as low yields in the bond market. Furthermore the interest available on bank CDs has dropped to practically nothing for the short term.

Many stock life insurance companies, which are active in the deferred annuity market place, do regular pricing studies and keep track of their own investments and the competition. Their rates for interest guarantees on new SPDAs are often below 4 percent. Some stock companies sell CD annuities which have a short guarantee of 1-5 years, after which the annuity renews. In the last year, the typical one year CD annuity has dropped its interest rate from about 3.25 to 0.5 percent and its 5 year guarantee from 4.25 to 3.25 percent! Overall fixed annuities have gone from 5.25 percent to 4 percent.

Comparison Between CD Annuities and Traditional Portfolio Priced Annuities

Traditional annuities are relatively simple. There is a back-end surrender charge lasting five to ten years, and the credited rate is based on the Company's overall portfolio regardless of whether the money is a new policy or in-force policy. Sometimes, there is a first year bonus. An annuity more commonly found in the brokerage market is called a CD annuity. This has a level interest guarantee for as long as there is a surrender charge. Then the contract renews, and the guarantee is the same as if the contract had been purchased for the first time. Sometimes different interest guarantees are offered, say one, three, five and seven years. The surrender charge for each guarantee disappears at the end of the guarantee. Naturally the shorter guarantees have lower interest rates. Because this was such a popular contract type, the lowered interest rates caused the interest guarantees to drop way below 3 percent for the shorter terms.

This is what triggered the crisis in deferred annuity pricing and one reason why the regulators acted twice to change the annuity nonforfeiture law. The other concern was that companies with flexi annuities in effect were creating an option for policyholders to put money to the company at guarantees which they could not afford to cover, perhaps so high that they could not even earn that much! This year I have encountered companies which had a 4 percent, and even a 4.5 percent, contract guarantee, but many are changing to the 3 percent.

New SNFL

Because of this crisis, the National Association of Insurance Commissioners (NAIC) created a temporary fix by allowing an interest rate of 1.5 percent but this had a sunset date, which varied from state to state when they adopted it, as many did. This year they passed the revision to the Standard Nonforfeiture Law for Individual Deferred Annuities. The heart of this is the indexing of the guaranteed interest rate. It is capped at 3 percent and given a floor of 1 percent. It is indexed to a five year maturity treasury rate less 1.25 percent.

There is a redetermination process. After the initial period, the interest rate can be redetermined based on a more current value for the five year maturity treasury. The purpose of this is to allow CD annuities to reflect current conditions. If a company offers a conventional annuity, it can let the initial period run until maturity, and effectively, forego the redetermination.

The consequence of this is that, if we continue in a low interest environment, the guarantee can be kept lower, and there will be a profitable pricing spread between the earned rate and the guarantee. The lower guarantee will not be hard to sell since it will only occur in an environment where rates are low. Thus comparatively speaking it will be reasonable. We do not want companies to have too tight a pricing spread between the earned rate and the guarantee; otherwise, they will go bankrupt. If interest rates move back up, the index will move up and will be capped at 3 percent.

I attended many of the conference calls where this was discussed. I noted the enthusiasm for passing it. Once it passed the NAIC, state adoptions have been following fairly quickly. Nine states have adopted it with effective dates in 2003, including Connecticut, Iowa, Minnesota and Texas. North Dakota's effective date is

There is a temptation to invest in longer maturity bonds since they generally have higher yields.

in 2005, and that for Oregon is 2004. Five more states are planning to adopt, including Wisconsin and Massachusetts. About three dozen states have the 1.5% minimum or something similar. A significant state not planning to adopt either law is Florida, which contains a lot of older people, who are prime candidates for buying annuities.

Both the financial management and marketing sides of a company should be following this. If there is a trend towards the 1.5 percent guarantee, you need not maintain a higher one. If there is a trend towards the indexed rate, you will have to learn how to monitor the treasury rate and the competition to keep your guarantee legal and competitive.

Actuarial, Investment and Marketing

Another problem is determining the crediting rate. You want to have a rate which will keep your current policyholders happy, attract new ones and still not lose money. Although first year bonus rates are popular, ultimately you must still make money from the spread between earned and credited. You are probably finding that new investments earn less than your current portfolio.

Does that mean that your new policyholders will get less than your current policyholders? Many smaller compnies do not do this. But if you credit both the same while new investments are earning less, the new policies will cause an overall lowering of the earned rate and hence the credited rate. Do you really want all this new business? Yet, the crediting rates on your in force policies are looking generous in the market now and are likely to retain policyholders.

There is a temptation to invest in longer maturity bonds since they generally have higher yields. This poses a danger if the interest climate should suddenly turn upward. Then, even the long bonds would not keep up with current new money yields and your portfolio rate would become non-competitive. Policies would lapse and you would lose because the sale of the bonds backing them would be worth less in the rising interest environment. What to do? It seems you are between a rock and a hard place. The new annuity sales are a tiger by the tail! You must seek a balance and study your investment approach.

Another strategy is to balance your annuity sales with life sales. Perhaps you should consider restricting new annuity money or selling more permanent life products. Should you shut off all annuity sales, or should they be restricted to be some proportion to life premium? Management and the field should have a common understanding of any steps taken.

Conclusions

Many brokerage-oriented insurance companies have been managing annuity money for years through up and down interest environments. They continue to do so. Our aging public continues to look for places to put their retirement savings, both for qualified money like IRAs and non-qualified. If the smaller and less sophisticated companies are going to continue accepting annuity money, the annuity line cannot be left on the back shelf to manage itself. Management must decide to spend time understanding and monitoring investments, regulatory developments and pricing spreads.

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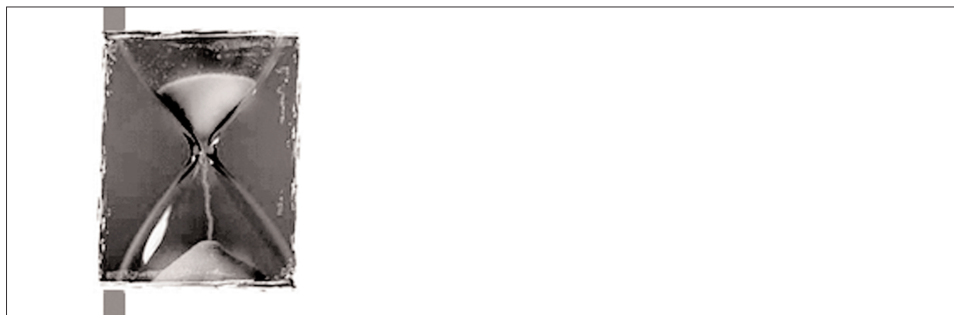
Smaller Insurance Companies and Long-Term Care Insurance



by Tony Proulx

Since the introduction of Long-Term Care Insurance (LTCI) in the 1980's, the marketplace has been dominated by a few large insurance companies. Sixty percent of the industry sales in 2002 came from the top six companies[1]. There are several reasons for this situation:

Some of these hurdles still exist today. However, the smaller insurance company now has a wide variety of help available.

- Long-term care insurance was an experimental coverage. The morbidity risk was not well understood. Although there may have been some comfort with the nursing home risk, the home care risk was unknown. If a carrier wanted to enter the marketplace, they needed to be prepared to learn from their mistakes. In addition to the morbidity risk, these long duration contracts also carry a significant re-investment risk.

- A company entering the long-term care insurance marketplace needed to make a significant investment in developing home office expertise and agent training. The product development, actuarial, compliance, underwriting, claim adjudication and sales and marketing functions are more complex than for any other line of business. For example, a very competent life claim examiner would be ill at ease when adjudicating claims based on a loss of activities of daily living definition. (The activities of daily living commonly used in long-term care contracts are bathing, continence, dressing, eating, toileting and transferring.) The critical mass needed to justify the investment in developing such expertise was estimated to be between $25 million to $50 million of inforce annual premium.

- Long-term care is a capital intensive product. There is a large first year loss. The risk based capital formulas are onerous. There is some relief when the volume of inforce long-term care insurance premium reaches the $50 million mark and the premium factor in the C-2 formula reduces from 38.5 percent to 23.1 percent. But the small er companies have no chance of reaching this level.

Some of these hurdles still exist today. However, the smaller insurance company now has a wide variety of help available.

- The long-term care insurance risk is better understood today. The recurring Intercompany Study of the SOA Long-Term Care Experience Committee provides a solid basis for many of the pricing assumptions. Actuaries also use the Non-Insured Community-Based Long-Term Care Incidence and Continuance Tables from the SOA. These tables are based on the National Long-Term Care Surveys sponsored by the National Institute on Aging. In addition to these sources for assumptions, some painful lessons have been learned regarding liberal benefit triggers, loose underwriting, cognitive impairment risks, voluntary lapse assumptions, etc.

- Reinsurance is available. This can help by transferring a portion of the morbidity risk and the re-investment risk. Reinsurance can also provide some relief of the capital burden and surplus strain. Financial reinsurance is available from off-shore companies. Risk reinsurance can be in the form of a quota share arrangement, or it can be a stop-loss form, aggregate or specific. The specific stop loss limit may be a dollar limit per claim or a claim duration limit.

- There is expertise for hire. Consultants can aid in the product design, pricing, product filing, administrative systems, financial reporting systems and experience monitoring systems. The consultants are there to get the product up and running.

- There are numerous vendors who can aid in the home office functions of continuing compliance, underwriting and claim adjudication. They can provide sales and marketing support, including illustrations and needs analysis systems. These vendors are generally very flexible in providing as much or as little hand-holding as desired. For example, the insurance company could agree to let the vendor initially underwrite all the applications. In the meantime, the vendor would train the company's staff. Eventually the bulk of the underwriting would be transferred to company personnel. The arrangement may call for the vendor to continue to assist on the difficult decisions. In this way, the smaller company staff still has

First and foremost is to keep your offering simple.

the vendor's expertise available. The smaller insurance company does not immediately need their own in-house experts. For some functions they may choose to always use hired expertise. They do not need to reach that critical mass.

- The Health Insurance Portability and Accountability Act of 1996 (HIPAA) granted tax-favored status to policies meeting the specified requirements. This has brought much greater uniformity to contracts. In 2002, 92 percent of all policies sold were tax-qualified. This standardization makes it easier for consumers to compare policies, but also leaves them with fewer choices in benefit design. In some sense, HIPAA created a more level playing field for the smaller insurance companies.

I believe all these developments eliminate or lower the hurdles of entry into the long-term care insurance marketplace. Notice that I said some are lowered, not eliminated. This is still a complex ever-evolving product. However, the long-term care insurance business offers some attractive rewards for smaller insurance companies.

The appeal of the long-term care marketplace has always been in its potential. There is a clear need for long-term care insurance. The average cost for a one year stay in a nursing home exceeds $57,005. This is a financial risk that few individuals can shoulder. The market is under-penetrated. There are only 5.5 million policies inforce.[2] There are 77 million people in the baby boomer generation. The oldest of these reach age 65 in 2010. All these facts contribute to a tremendous untapped market.

Offering long-term care insurance will benefit your distribution force. Long-term care insurance is a high premium product. The average annual premium is nearing $2000. The large premium generates large commissions. It can provide significant supplemental income for the agent. An additional product offers an opportunity for cross selling and can open the door for a complete review of a client's insurance needs.

The long-term care insurance product generates very large active life reserves, especially when inflation protection is included. The high active life reserves provide an opportunity for the insurance company to earn additional profit on their investment spread. The flip side, of course, is the re-investment risk.

I have some advice for those smaller companies seriously considering entering the long-term care insurance marketplace. First and foremost is to keep your offering simple. Avoid the bells and whistles. In my opinion, long-term care insurance is meant to cover catastrophic expenses. The insured does not need a prescription drug benefit, a wellness benefit or a medical response system benefit. These ancillary benefits add little value, may only confuse your agents and will keep your claim examiners busier than you would like.

Also, under the heading of simplicity, I suggest keeping the number of plan options limited. Very few applicants choose a 180 or 365-day elimination period, so don't even offer them. Avoid 0-day elimination periods. They have had poor experience. A longer elimination period will weed out trivial claims and help control the claim volume. Be sure there is a large enough spread among the available benefit periods. For example, offer a choice of two, five and ten-year plans. This gives the insured the choice of minimal, medium or maximum coverage. Don't offer plans that are too close together. Keep the choices meaningful. Avoid having to explain why a six year benefit period costs only 5 percent more than a five year benefit period.

Another important consideration is the contract type. There are three types. The reimbursement model pays benefits based on actual expenses incurred. The indemnity model pays the full benefit, regardless of the dollar amount of expense incurred. The disability model goes one step further in that it pays the full benefit without requiring that any health care services be provided. Of course, all three types require that the claimant meet the benefit trigger, such as, loss of activities of daily living or severe cognitive impairment. I recommend the indemnity model for smaller companies. Some actuaries argue that the reimbursement model is better because it avoids over-insurance. I believe if the disability is severe enough to cause the loss of activities of daily living, then the insured will have enough non-medical expenses that over-insurance is not a concern. Also, the indemnity model eases the adjudication process. The examiner does need to review every bill in order to determine the benefit amount.

I do not recommend the disability model for smaller companies. I do have concerns with over-insurance with this model. Also, it places greater emphasis on the examiner's determination of satisfaction of the benefit trigger.

Underwriting is everything! The expected claim incidence is very low. A few extra claims from weak underwriting can be disastrous. Use the expert services that are available, at least until your own underwriters are sufficiently trained.

Finally, price your products conservatively. Typically smaller companies will have little competition for long-term care insurance. Smaller insurance companies tend to have market niches where their competitors usually do not even offer long-term care insurance. They may have a captive agency force. The current environment is conducive to conservative pricing. Many large companies have implemented rate increases recently. The product is priced to be level premium, so these increases have not set well with the regulators or agents. They present a significant burden to a senior person on a fixed income. In response to this situation, the current NAIC LTCI Model Regulation has removed the minimum loss ratio requirement. Instead the Model Regulation emphasizes rate sufficiency, placing increased responsibility on the pricing actuary to encompass "moderately adverse" experience deviations into the initial pricing. Regulators feel that policyholders are better served paying a higher initial premium with a smaller chance for future rate increases. At last count, 17 states have either adopted the new Model Regulation or their own form of rate stabilization.

In summary, I believe that there is a place in the long-term care insurance market for the smaller insurance company. The carrier needs to utilize the services of outside experts. Their product should be simple in order to be more easily understood and more easily administered. Now is a great time to take the plunge!

Underwriting is everything!... A few extra claims from weak underwriting can be disastrous.

Recent emphasis has been on rate sufficiency and not rate competition. Market penetration is low and, with the graying of the baby boomers, the potential is tremendous. A well-designed, appropriately priced long-term care insurance product can be profitable for you and provide financial security to your policyholders.

[1] *Glickman, James M. 2003 "Fifth Annual Long-Term Care Insurance Survey." Broker World July.*

[2] *Ibid*

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Small Talk is published quarterly as follows:

Publication Date	Submission Deadline
September	July 21, 2004
December	October 21, 2004

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