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LONG-TERM-CARE REINSURANCE

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Long-term-care (LTC) is a relatively new product. This panel will cover the current status of reinsurance for this marketplace in three ways.

- Traditional accident and health (A&H) reinsurance for LTC
  - Coverages available
  - Who should consider?
  - Extent of marketplace
- Turnkey programs
  - Services available
  - Reinsurance available
  - Who should consider?
- Assumptive reinsurance
  - Considerations of buyer
  - Considerations of seller
  - NAIC model
  - Impact of regulation

MR. GARY L. CORLISS: This is the fourth of seven long-term-care related sessions that are on the program at this meeting. This session is dedicated solely to long-term-care reinsurance as it exists in varying forms. This program is broken into three main parts. The first portion on traditional reinsurance will be covered by Mike Brodrick from Lincoln National. The second portion on turnkey programs with reinsurance will be covered by me. I'm from Duncanson & Holt Reinsurance Managers. The last portion on assumptive reinsurance will be covered by Lenny Koloms from Benefit Trust Life.

MR. ROBERT M. BRODRICK: I'm going to talk about traditional reinsurance or what I'd prefer to call conventional reinsurance. This is different than more full-service, turnkey offerings that Gary is going to discuss, and assumption reinsurance that Lenny is going to cover. Conventional reinsurance is the old life/health kind of reinsurance that has been in the industry for many years. First, I'm going to go through a list of the risks that are inherent in most insurance products and how they relate to long-term care, just so that we have some feel for the kinds of risks that the ceding company and a reinsurer are sharing together. Then I want to discuss the kinds of reinsurance currently available in the industry. I've listed all that I'm aware of and I want to talk about how they function. Third, I want to cover some very basic treaty provisions and how they relate to long-term care, and the principal differences in treaties covering long-term care compared with other life disability income reinsurance coverage. Fourth, I'll be talking about considerations that a company might make in choosing whether or not to reinsure, how to reinsure, what product to use, and what type of reinsurance to buy. Last, I'll talk briefly about the extent of the long-term-care reinsurance market. That'll be a very brief portion because there's not a lot known about the extent of the long-term-care reinsurance market.

Now, let's cover the general risks associated with long-term-care reinsurance. Six items capture the kinds of risks inherent in most insurance products that are on the market.

One is the interest rate risk. We can think of this in terms of either the coupon rate or the total return including any asset devaluation. You might want to consider total return as the true investment risk you take as a direct writer when you hold funds on behalf of a policyholder in the form of reserves. It's not wise to treat interest rates as a minor decision in your pricing. It's an assumption that a reinsurer must buy into when he buys into your pricing. Both interest rate achievement and asset growth or devaluation can be shared with a reinsurer through certain products.

Mortality is the next risk which most companies throw in with the lapse risk in their pricing process. It's considered part of a lapse decrement, as opposed to a meaningful separate factor for pricing long-term care. That holds with the exception of any policy with return of premium benefits. Obviously, then the morbidity table becomes a major factor.

The lapse risk or as I like to refer to it, the expense risk, varies significantly based on the proportionate size of your up-front expense. Are you a high front-end load and marketing expense operation or not? Obviously, you are going to have underwriting and issue costs to a certain extent, so there will always be some risk in this area. What are these risks? For one, I think national health care may be a substantial threat. Medicare had substantial long-term-care benefits at one time, and that was a substantial threat to private industry. If that had continued, it's possible that the government program could have eventually killed off this industry. The risk of not being able to amortize your early expenses is real in the current long term care market. That is a risk that we all share.

Another risk is expense, that is, strictly expense not related to lapse. Is the risk that actual expenses incurred in administering a policy exceed your assumptions or your inflation assumptions for expenses? That's a risk shared by both the direct writer and reinsurer.

The next item is morbidity, and that is definitely the main issue. This assumption throws fear into the hearts of everyone because there is no substantive insured data generally available. There are a couple of companies with large blocks who have experience, but it has not been shared in the industry so far. The public data available is hard to convert. You are skating on thin ice in trying to convert that data into a pricing table, but it is done by a lot of companies with a lot of coverage these days. I would say that the morbidity factor is what drives most companies to seek out reinsurance in some form. The product generations are becoming more stable now, but for several years, products had morbidity that was not very homogenous. By using current books of business, can anyone feel very confident that they have a fix on the real claim costs for their current generation of long-term-care products?

The next risk we share is the regulatory risk. One example relates to the deductibility of interest on reserves. I don't believe we have a statute allowing deductibility. However, most companies are taking the deduction as though it were permitted. Hence, there's a small risk that the treatment may not be favorable as it becomes law

in various states. I mentioned, relative to the lapse risk, that there is also some threat of a national health care bill invasion into long-term-care territory. Finally, in thinking of the regulatory risk, some states may be difficult about permitting rate increases on any kind of guaranteed renewable product. We have the potential for not getting rate increases when they are really needed.

The final risk is that of the economic cycle. Just as surely as the downturn in the economy can hurt a disability income book of business, I feel that a severe downturn long-term-care morbidity could adversely affect this. It's not direct, however. The extra morbidity is going to occur when someone who has been boarding a marginal claimant (someone who hasn't gone into a nursing home due to family support) loses his or her job. Loss of a job due to economic downturn or for any reason actually will cause economic pressure combined with precipitate movement of this marginal claimant from family support status to a long-term-care claim.

As the second major subject, I want to cover the reinsurance coverages available in the industry and how they relate to the already mentioned insurance risks. Also, I will cover the basics on how these products work. Coinsurance is the old standard. It's also called original terms reinsurance. It operates with the ceding company sending a specified portion of its gross premium to the reinsurer. The reinsurer provides allowances that are usually patterned after marketing, issuing, and underwriting expenses to a large extent. The risks transferred by a coinsurance arrangement to the reinsurer include all risks except the first-year expense which generally is not totally covered by a reinsurer. Perhaps, it comes close. Coinsurance does catch all of the six risk elements that I identified earlier.

Modified coinsurance (modco) is the next form, and that is, as it says, a modified form of coinsurance. Everything mentioned about coinsurance also applies here as premiums and allowances are exchanged. The primary difference is, with modco, the reserves are loaned back to the ceding carrier, placing the interest rate risk back with the original company.

Extended wait reinsurance is a nonproportional form of coverage in which the reinsurer comes on the claim later than the direct carrier. Take an example of a 100-day wait, long-term-care plan with extended wait reinsurance. The reinsurer may participate in that claim at the one-year point, the two-year point, or the five-year point. The risk covered by this reinsurance is essentially the long-tail morbidity. Of course, the economic cycle risk would also transfer as well.

Spread of loss is a form of portfolio reinsurance generally based on aggregate morbidity for an entire book of business, usually sold at a fairly competitive initial rate. The primary attraction of this coverage is the competitive initial reinsurance premium rate. In exchange for that competitive initial rate, the reinsurer gets the right to raise rates in ensuing years should the morbidity experience be higher than expected. The risks covered by that form is basically the same as extended wait: the morbidity risk and the economic cycle risk. Since it's essentially a YRT coverage, very little of interest rate risk is transferred.

Stop loss is another form of reinsurance. It also is a portfolio keying coverage on a loss ratio. I'm not sure how these are priced. In my view, it would be most difficult

to price a stop loss cover for a long-term-care book, but I know that they are sought in the market, and I know that reinsurers have tried to price them. However, I believe that the confidence level is very high. I don't believe this may be an opportunity for a reinsurance buyer. The risk covered is again twofold: the morbidity risk and the risk of economic downturn.

Strain relief reinsurance coverage is designed to provide relief from surplus strain resulting from issuance of a long-term-care product. This is generally in a coinsurance or a modified coinsurance form. The main difference from conventional reinsurance is that the allowances are quite low which protects the reinsurer from most deviations in morbidity. There is very little, but some morbidity risk is included in this kind of cover. There would be some lapse and some regulatory risk and probably the risk of economic downturn.

One cover I have not mentioned is YRT. YRT is essentially an attained age rate scale similar to what might be used in a spread loss contract. However, YRT is generally sold on an individual cession basis and the rate is applied per the attained age of each individual policyholder. The risk transferred with this type of reinsurance is essentially the morbidity risk only. No other risk is involved.

Now I want to talk about some basic treaty provisions. First, let me talk about company retention a little bit because long-term care is somewhat different than reinsurance arrangements for life and disability income (DI) which are largely excess share. The average long-term-care benefit is probably around $80 or $100 per day. Some carriers may have higher issue limits. Issuance of $100 a day is $3,000 a month. That pales in comparison to a $25,000 DI policy with lifetime benefits. Thus, the basic risk in long-term care, even with a cost-of-living adjustment (COLA) is at a fairly low level compared with life and DI insurance. Hence, the needs are not excess share. Instead, they are quota share needs with reinsurance being sought because direct riders are not confident of their morbidity assumptions. Hence, the retentions in a traditional long-term-care reinsurance deal tend to be quota share. That means that the reinsurer takes a certain percentage of each risk. A lot of these reinsurance arrangements are on a 50/50 basis.

Another major element of any reinsurance treaty is the automatic limit. Most treaties are fully automatic, which means that the reinsured company is not required to submit papers for underwriting to the reinsurer. A reinsurer generally would want to keep tabs on the underwriting process through a periodic audit. That is what we do at Lincoln National, and I know that other carriers do the same thing. Recapture is 10 or 15 years generally, although a lot of the business is expected to be off of the books at that point, so it is a fairly moot issue.

Let me move now to considerations for long-term-care reinsurance coverages. What should you think about when you consider reinsurance? You should first think about whether or not you even want reinsurance. What do you want it for? I would submit that the considerations are primarily risk-sharing. How do you want to share this risk? Do you want to share it at all? Part of many reinsurance arrangements include the delivery of expert services by the reinsurer to the reinsured company.

As far as risk-sharing is concerned, if you're a small company, even a $3,000-per-month lifetime benefit can be a large lump to swallow. A small company just simply can't afford to take all that risk. Companies new to the long-term-care field probably are thinking of risk-sharing out of fear of the morbidity assumption. Larger companies with a low risk tolerance seek reinsurance on long-term care, simply because it's new. They want to have two heads looking at this new product with them. So, it's a little bit of fear, a little bit of need for comfort, and a desire for a partnership. Some companies, including large companies, have a fairly low risk tolerance as part of their corporate culture.

I mentioned partnership companies. A partnership company would be a company doing long-term-care business, but for some primary motive other than being in the LTC business. Those motives might be for getting the administrative fees (with its attendant risks) but without a great deal of interest in actually sharing in the morbidity risk. Another type of partnership company is one with a desire to fill a need for its agency force. The agency force may want a long-term-care product, and they want it on their paper, so the "partnership" company decides to use its paper with the product. However, they would become partners with another company that would act as a TPA, and they might pull in a third company as a reinsurer to carry the bulk of the risk. Those kinds of arrangements are happening all over the industry at this time.

Expertise-sharing is often sought in new product lines. Small companies have difficulty keeping expert staff in all functional areas and oftentimes will look to a reinsurer for support with things such as underwriting, claims management, and case management. Since long-term care is a relatively new specialty field, they might look to a reinsurer to help them build their expertise through underwriting and claims handling assistance. There may be pricing assistance as well. Partnership companies may not have expertise in any long-term-care functional area and look to a reinsurer for support in all areas.

Sales growth can cause surplus strain. If a company is close to the line on surplus-to-assets ratio or is fighting to keep a AAA rating, reinsuring a substantial portion of long-term-care new issues may ease the statutory impact. Modified coinsurance and coinsurance or any of the substantive premium forms of reinsurance do help with surplus strain.

As a last topic, let me mention the extent of the long-term-care reinsurance marketplace. As I said earlier, it's not widely documented. I don't know of any data that are collected anywhere. However, I would hazard to guess that the reinsurance premium in the marketplace is in the neighborhood of $100 million. That seems like a lot, but since this is quota share, it is really not a terribly significant share of the total long-term-care reinsurance premium. There are major players in the marketplace -- I won't name them -- but I'd say about half of the major life and DI reinsurers are in the market to a certain extent. There are a couple of pools active.

I also want to mention reinsurance in Europe because what's happening is surprising. There is long-term-care insurance businesses over there. British and other continental companies write long-term-care direct products. They seek reinsurance in the U.S.

It's more developed in Europe than you might think. It's something to watch for as you read the trade publications.

One last comment relates to group covers. Most of the group arrangements that are occurring are really individually underwritten business. Even though the policy form itself might be group with certificates, they are individually underwritten and would fall under a conventional individual reinsurance deal.

MR. CORLISS: The general overview that Mike gave of the marketplace relates to those companies that may have developed their own product. Their reinsurance search is for a particular solution to one or more of the risks that Mike mentioned. Some companies, for various reasons, may decide that they would like a substantial amount of help in entering the marketplace. Turnkey programs have been developed by some reinsurers and reinsurance managers to assist with the company's entrance into the long-term-care marketplace. It might be good to start with a definition of what a turnkey program is. One is that it's a program to assist other insurance organizations in entering into a new product line. The idea behind a turnkey program is that there is a long-term-care product machine that has been built by someone. That product machine is given to someone else who then turns the key, and the machine starts performing -- a very basic concept. The key that has to be turned in turnkey programs as a minimum is the marketing portion of the whole product. Therefore, all of the other functions related to the development of the long-term-care product are taken care of by an organization different than the one that actually has its name on the product and is marketing it. Another way to look at it is that someone else is the "back office" (or third party administrator) for a particular company. More specifically, what does the "back office" do and how do turnkey programs work?

I'm going to cover the answers to this question in three segments. I'll cover the functions that are provided by a long-term-care turnkey organization, the reinsurance protection that is typically used with that product, and then the considerations related to using that product? These considerations get into the three issues that Mike mentioned -- risk-sharing, expertise-sharing and strain-sharing.

Let's start with the functions being made available by the turnkey operator. I break those into three main categories -- development services, administrative services, and supportive services. Development services are those related to actually getting a product ready to market. Development services have various components. The first is to design exactly what benefits will be offered. What will the program be? What will the insurable event be? What will the varying benefit parameters be such as benefit periods, benefit amounts, maximum benefit periods, exclusions, limitations, whether there is or is not care management. Second, once those features are known, then what are the premium rates for such a product? The product is priced. Once that is finalized, the need is for a draft of the actual contract and then filing the policy. This includes not only the individual contract but the outline of coverage, replacement notices, and all the various other forms such as advertising material that need to be prepared. The development services are the starting point.

Once the product is designed, priced, filed, and approved, administrative services may be needed. There are a number of administrative services to discuss. Everyone who

says they have a turnkey program may not have every service that we are talking about. They may have only portions of those services available. Mike mentioned partnership companies and TPAs for example. As we cover turnkey programs, if you look at administrative functions, you will note that they are quite TPA-oriented.

First, the administrative service is the actual underwriting process. This process includes gathering of underwriting information, evaluating the application, securing whatever information is necessary by the various means, and making the underwriting decision. Will the policy or the certificate be issued to a particular individual? Once that is completed, for those who are accepted, the policy issue process is completed. Carrying forward from there, collecting the premiums, doing any consumer services, paying commissions to agents, paying claims when they occur and then ending up with a complete accounting for all of those services that have been completed. All funds are reported on from the day that they are received right up front with an application through the whole process of renewal funds coming in and being expended.

The last category is supportive services that may be available and associated with the product. The organization that is involved is doing all of the administrative services and should have all the records to be able to do a number of things for the carrier company. First, they'll help the company stay in tune with changes in regulation and any restrictions that are needed such as rescission reporting forms, the varying statements that need to be submitted to the NAIC relative to premium lapses and loss ratios, as well as any other particular requirements that come out of either state or NAIC model activity.

Second, and very important, is the preparation of a database for the carrier. The turnkey organization should have that capability in place. Then, the company entering the business can analyze its business right up front. Report generation may be a help to the marketing area. Maybe reports will help the underwriting area do a better job with the kinds of clients that are applying to this organization. Then critically, the turnkey operator can certainly use the database to move into experience monitoring. Careful monitoring is so crucial in a product that it is expected to have a low claim frequency, particularly in the early years. It is important to be able to look at early experience, compare actual to expected and be prepared to take the next appropriate steps of either decreasing or increasing the rates as needed over time.

Mike covered the varying kinds of reinsurance that are typically available for long-term-care insurance in the overall marketplace. For turnkey programs, coinsurance or quota share reinsurance are the typical forms that are used. There is actually some sound rationale behind this. Certainly any organization that has written the contract, priced the product, made all the underwriting decisions as well as the claim decisions ought to be willing and able to step up and participate in all of those risks that have been worked into that product. Therefore, it is very reasonable and realistic that coinsurance is the one form of reinsurance that is typically utilized because it shares in all the risks taken. YRT may be used occasionally, but far and away, quota share or coinsurance is the one that is predominant.

What would the considerations be for a particular company getting into a long-term-care turnkey program? Some folks might think right up front that there are some

basic parameters that you could use. This must be a program for small companies to use, and, yes, to a large extent smaller companies may use turnkey programs more often. There are a number of reasons why that's not necessarily the whole picture. For example, as we start off with market entry, there's certainly been a lot of changes in the insurance industry and in the staffing over the last few years.

So, it's difficult to get into a new market because of varying considerations. A company may really want to get into the market to gain expertise, but it may not want to take a lot of the risk. It wants to get started now. It's not uncommon that those that do the best in an industry are the ones that get in first. The man that introduced the hula hoop made the most money out of the whole process, and those who came along later made less or it was more difficult for them to get into the business or they failed, and it won't be any different in long-term-care insurance.

Well, what about the development expense? What if this product does not take off? Some companies have found that for their organizations, it does not. Well, if they've committed major resources and built up a large organization to handle this product, they may find that they can't recover that. So, working with an organization that has a turnkey program could help minimize that development expense up front. Some systems may not be able to handle one more product -- already strained to capacity -- and if there's a turnkey organization that already has that capability in place, it makes it (1) easy to get started, and (2) means that all the other major products being handled by systems in the organization can continue to be taken care of. That's an issue that is not related to company size. Large companies certainly have long lists of things for their systems people to do, as do small companies.

Speed of entrance into the marketplace can be enhanced with a turnkey program because most of this work will have already been done subject to a little bit of tinkering and modifying to make it work for a particular company.

With all the changes going on in organizations there may not be staff available to actually start in a new area. Maybe they do have the capability to have that expertise but are just not available because of other products that are asking for resources as well.

Certainly risk reduction is important because reinsurance is typically an integral part of the whole process. The turnkey reinsurer will be willing to take a significant portion of the risk. Strain reduction can also occur if the reinsuring company takes a significant portion of the risk on a quota-share basis with appropriate expense allowances. The strain that then shows up on a company's statement is minimized. Lastly, a quota-share turnkey arrangement is a real partnership arrangement. A writing company has someone that is equally as interested in you achieving a good result. This concludes the varying considerations for entering into a turnkey arrangement and the services that are available. All of these comments have been related to helping a company get into the line of business.

The third part of our program, which Lenny will now cover, is if the turnkey product developed by a turnkey operator or the product you developed within the company doesn't work then someone else can help you get out of the business with assumptive reinsurance.

MR. LEONARD KOLOMS: As Gary has mentioned, our company is a purchaser of blocks of business. Sorry to say, however, we have not purchased any blocks of long-term care. While I don't have experience in long-term-care acquisition, the experience gained in the acquisition of other types of business qualifies me to be here. While we haven't assumed long-term-care blocks, we are interested in this market. We will look at any type of health business we are set up to administer. Benefit Trust Life has been in the health business for close to 80 years, and 90% of our premiums are from health insurance. All the products, including long-term care, are part of our standard portfolio. Until recently, there have not been long-term-care blocks for sale. This is because of the limited number of players in the marketplace; therefore, only a limited number of companies are trying to get out of the business. I'm going to cover why companies decide to sell a block of business, the considerations in choosing a purchaser, why companies want to buy blocks of business, and the concerns of purchasers.

There are many reasons why companies want to get out of the business. However, in most cases they are financially related. One reason given is that sales are not high enough. This means expenses are too high; too many valuable resources are spent on a declining block of business; it takes away from your regular business. Another way to say it, you're spending too much time on one block that isn't making much money and diverting time away from other blocks where you could be making money.

The other situation is where sales are high enough but you are losing money because of pricing or underwriting mistakes.

Another reason for selling a block of business is to reduce the level of risk-based capital. It is expected that the NAIC will adopt a risk-based capital formula this December. Under the formula, your surplus will be measured against a formula-determined risk-based capital. If a company has a business that is ancillary to its main business that is not producing a product and is diverting attention from your regular business or limiting the amount of new business it can write, that company will be deciding to sell some of these ancillary blocks of business. Companies have other options besides selling the block which Gary discussed. Under the alternative, you have limited administrative responsibilities and with a large portion of the business being reinsured, risk-based capital will be reduced. The choice between Gary's approach and selling is whether or not you still want your name on a product where you have very little risk with someone else doing the administration.

Another reason given for selling a block that is different than the main business is that the business is too much. Companies get into a business and then find out that it is so much different that it results in high expense rates. Long-term care is substantially different than life, in claims, underwriting, state regulation, etc. In addition, companies are finding that it requires a lot of actuarial and legal talent to cope with a long-term-care block of business.

I'd like to talk about what to look for in a purchaser. The considerations are different than looking for a general reinsurer. If one is going out to sell a block of business, you are looking for someone to take over the administration and risk. When looking for a reinsurer, you are looking for a risk taker only. When evaluating a reinsurer,

you're only looking for long-term financial stability. You want to make sure that the reinsurer will be there to cover any losses, that you will be able to take credits for reserves on your annual statement, and that you're not going to be criticized by the state or your auditors for your choice.

However, when you are trying to sell a block of business, you've got to look for more than that. What you will look for will depend on who bought the policies you are selling. In a lot of cases the people who bought those long-term-care policies may also have purchased other coverages with your company. In these cases, companies will be very concerned with how the purchaser is going to handle his policyholders and agents. You don't want a complaint going to your president because the way the company is administering the business is not up to your quality standards. In thinking about selling a block of business, you must define, in advance, the qualities you are looking for in a purchaser. The financial side is important. However, the quality of service may be more important. Another is whether the company is committed to the business. We have purchased blocks of business that contain blocks of business purchased from somebody else, who purchased it from somebody else, etc. If you really are worried about your policyholders, you've got to worry about whether the company is really committed to that marketplace. Will the purchaser change its mind and sell your business to someone else?

You must also worry that reinsurance be licensed in the same states in which the business was sold. The regulators are very concerned that by selling the business, you've taken a policyholder out of their regulation. This is, of course, not true when you're looking for a reinsurer only.

Not being competitive in your main business is another thing companies worry about. Companies find it hard to justify the sale of a block sold to one of their competitors especially if they have other policies with the company. Even though it may not be the business that they're in, you are turning your policyholders over to a competitor. If the policies were sold by your agency force, you may have a difficult time trying to sell it to someone else who is also in your main business. A casualty company may find it very difficult to sell a block of long-term-care business, for example, to another casualty company. Or a life company may be very concerned about selling it to someone who is also their competitor and is of their same stature. However, I have not heard of business being sold by the Metropolitan to the Prudential. Another concern is that the agents and field managers will end up dealing with the purchaser.

Experience in acquiring blocks of business should be a consideration in choosing a purchaser. I can tell you horror stories because of purchasers' inexperience. When you acquire a block of business, you are taking over the administrative functions beginning on the same day, and that means you have to convert from their administration system to yours. You can imagine what would happen if the purchaser makes a mistake in the way it coded up its conversion program to convert your files to theirs. For example, billing the annual premium every month because of a misinterpretation that the annual code which said 12 really meant once every 12 months, not 12 times a year. There are cases like this that have happened. This is one of the reasons why it seems to take a long time for the purchaser to be ready to administer a block of business. Don't let anyone fool you. If you are trying to get off the administration of a block of business, don't expect to take the place in less than four

months after you have reached agreement with the purchaser. The systems people need a three-to-four-month period.

Flexibility in financial arrangements may be another consideration by a seller in choosing a purchaser. Some sales may require creative financial arrangement especially if being sold because of financial problems or special GAAP and tax needs. There are many ways to structure your financial arrangements. Of the 17 blocks of business that we have purchased, we've had 10 different arrangements and every new one seems to be different. We have purchased blocks of business from companies that have had substantial losses for long periods of time. It required creative financial arrangements to meet both company's needs. In selling a block of business, each company has to recognize what that business is worth. It may have a negative value. Once you make the decision to get out of the business, and once you put a value on the block, even if it's negative, recognize that if you are looking for a quality company, there will be somebody who will find all the problems. To come to the agreement it will probably cost you something. In a number of cases, it may be less if the company has lower expenses and has expertise to manage the business. Why purchase blocks of business -- profits. Why should you sell new business, and we purchase blocks? All for the same reason -- to make money. However, there are other reasons. One is that it is a fast way to get into the business and give you expense money to cover new administrative systems and it allows you to hire more qualified claims people, etc.

Learning from other companies' experience is another good reason. If you are in acquisition business, you see the mistakes other companies have made. You see what works and what does not. As you know, in the health business, you get a fast feedback on your underwriting rules, and that is true of long-term care. As your claim people talk with you, the underwriters modify your underwriting rules. The same thing happens when we look at a block of business. We learn a lot of what works and what does not.

Increased volume is another major reason. This allows you to reduce expenses, put in better systems and have more technically qualified people. This is the major difference between the companies with large blocks as opposed to smaller blocks. I find it very difficult to see how companies that are not dedicated to this business can survive. For small blocks of business, expenses will have to be higher than major players. Not only are small player expenses higher, their expenses are used for things that are different than those of large players. We are spending on management information systems and more qualified technical people, such as those involved in underwriting, actuarial, legal, and claims functions. This allows us to help keep down all our claims compared with companies who are just dabbling in the health business. Just like other types of health business, long-term care is something not to dabble in. You can make costly mistakes. I have already seen them.

Use of available surplus is another reason. There are companies who do have excess surplus around, and purchasing blocks is a fast way to increase risk-based capital.

I would now like to discuss concerns of the purchaser. Can arrangements be a win-win situation? I would say from our perspective that that is the first thing we look at in any block of business. We try to come to agreement as to what the problems are

with that block of business and the needs of the seller? If the companies cannot agree upon a concern, it will be difficult to reach an acceptable arrangement. We have purchased blocks of business from companies who had substantial losses prior to selling us the business because they agreed that they had losses and that losses were going to continue. As an example, there is a block of business for sale -- it's only going to be sold to a purchaser who makes a mistake. The medicare block has an accumulated loss ratio of 40% with a lifetime requirement of 60%. In order to meet the lifetime loss ratio, the block of business in the future has to have a 131% loss ratio.

However, the company is not willing to admit that it needed 50-60% of future premiums as an active life reserve. Without this agreement between the parties, a financial arrangement is not possible. The company is trying to find someone who will make a mistake. So, when a purchaser looks at a block of business, we try to make sure that we can meet the other company's needs and that their needs are a mesh and consistent with the experience.

Another thing purchasers are looking for is whether the administration meshes with its own. If a purchaser needs to spend a lot of money on an administration system just for the block, you probably won't be able to reach an arrangement with the company because of your charge in the appraisal, unless the block is extremely large.

I think replacements and control of business are two more things for which purchasers are looking. An example of that would be the situation that Gary is talking about. For example, if the administration is being done by a third party administrator, as Gary has described, and the reinsurance is being done by someone else, most purchasers would not even consider talking to the seller because Gary's company has a substantial advantage. He does not have to cover the business. If there is a chance that you think you may not be in the business for a long time, I would suggest that you strongly consider Gary's arrangement, because at some point in time, you may want to sell the block of business and Gary would be able to accomplish it easily.

I would strongly suggest that if a company decides to get out of a business that it does it immediately after making that decision. The larger the block of business, the better the chance is of selling it. It is a more desirable piece of business. There are some companies that have waited too long, until the business has gotten too small. When that happens, you are going to lose money. Your expenses are going to be very high. You are not going to manage the business. You are not going to be able to keep qualified people in either the claim or actuarial departments who know anything about that business. You won't be able to keep up with the regulations, and when it gets down to that point in time, you will find that you are not going to find a really qualified company who will be willing to purchase that block of business from you. Another comment on control of business. There are situations where business is being sold through managing general agents (MGA). That would be a situation where the seller would want to come to an agreement with that MGA before appraising the block.

Payment structure needs of sellers are a big concern of purchasers. There are a lot of ways of structuring payment to meet a company's federal income tax, deferred acquisition cost, and statutory needs. Under the new tax law, any transfers of

monies under a reinsurance contract (and that includes active life reserves, which are considered as premiums), are subject to the 7.7% proxy deferred acquisition cost. The assuming companies are going to recognize this in their purchase prices. The same thing is true of tax basis reserve. The assuming company can only deduct for tax purposes, the tax basis reserve. These items have the opposite effect on the seller. When you sell a block of business, you add active life reserves to income and get to deduct the payment to the purchaser. However, from a tax standpoint, you add the lower reserves to income.

State regulations. The NAIC is very concerned with the selling of blocks of business from the policyholder standpoint. There have been a number of companies that have gone under that had purchased blocks of business from other companies. The policyholder may have bought from a company because it was an A+ rated company. Can it sell the policies to a B company? The NAIC is very concerned with this, and it's going to require the policyholder be given a chance to say no to the deal. They want to allow the policyholder to look to the selling company for purposes of providing the coverage it purchased. Let me expand.

Under assumption reinsurance the policyholder gets a sticker with the purchaser's name to paste over the seller's names on his policy. He is told he can never look to the seller anymore for any kind of services or benefits. This is the concern that the NAIC has. The NAIC is addressing what will be considered.

Is a payment of premium a sufficient way of accepting the arrangement or is some other kind of response required? Purchasers in this business have to have the ability to operate both under an assumption basis and be under an arrangement of 100% coinsurance with an administrative service agreement. We have that ability and are operating in other companies' names. We have arrangements where we answer the phone with another company's name, and send out premium notices, and claim and commission checks in the other company's name. If you are thinking of selling a block of business in the future, you are going to have to make sure that the purchaser has the capability of operating in your name.

MR. FRANK E. KNORR: I have two questions about facultative reinsurance. Is any facultative reinsurance available? Is there a demand for it?

MR. BRODRICK: There is a small demand for facultative reinsurance. It is used primarily by a company without a long-term-care underwriter. Let's say a company just started in the business. They may be going faster than they can gather their resources. A new company in the business will turn to a reinsurer for some underwriting advice on a case-by-case basis which is essentially facultative underwriting, but it's not the norm. It can be done that way, and reinsurers are willing to do that for awhile, but ultimately, reinsurers expect that the direct rider would develop its own expertise, maybe with the help of the reinsurer, and get it back to an automatic kind of arrangement. On an ongoing basis a reinsurer will always welcome a facultative submission for our opinion on a case that is tough to underwrite. We've always had that service and it would be part and parcel of any automatic arrangement that we make.

MR. PAUL S. WALKER: Question for Lenny. You talked about 100% coinsurance on these assumption deals where the policyholders object. Won't the new fronting regulation reduce that to a 50% deal?

MR. KOLOMS: I'm sorry. I have not followed the fronting regulation. Essentially they forced it on themselves. What is the option? Should a company with one or two policyholders try to administer? I mean that's ridiculous. I know that they have that in the small group in order to prevent the companies from getting around the small group regulations, but they do allow the commissioner to make an exception. I've got to believe that a fronting arrangement like you're talking about may pass because it is not made for the selling company to get around the rules by using another company where it's not licensed to do business. I thought that most of the fronting was with those kind of companies that weren't licensed to do that kind of business. That was a way of avoiding it. Therefore, I'm not too sure whether or not it really applies to what we're talking about. In our case we are licensed in those states that do that business and are actively selling in those states.

MR. CORLISS: Lenny, based on your comments about the NAIC and model and its discussions around a model regulation and the insured choice issue that you mentioned, what do you see as the future for assumptive reinsurance?

MR. KOLOMS: In our case we are equipped to handle it. I mean we have five administrative and coinsurance agreements to handle. You have to give everyone an option in New York. The question is whether or not you have the administrative systems in place to do what Gary is doing at Duncanson & Holt. You are acting as another company. And so we are equipped to operate in another company's name. Now, I'm not sure if other companies are. This will limit the number of purchasers.

MR. CORLISS: So, limitation would seem to be the obvious result, if there are fewer players that'll be capable of accomplishing that.

MR. KOLOMS: Yes.