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HEALTH GAAP TOPICS

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Health GAAP topics will be discussed. Particular emphasis will be placed on mutual companies preparing initial GAAP statements.

MR. ROBERT SHAPLAND: I'm a vice president and actuary with Mutual/United of Omaha Insurance Company. Joining me is Bob Beal, who's with Milliman & Robertson; Helen Hofmann, who's with Bankers Life and Casualty Company; and Max Rudolph, who works for Mutual/United of Omaha, is our recorder. Bob Beal will give us some background on how mutual companies are being brought under GAAP, and then also give some experience on GAAPing some disability insurance with a previous employer. Helen Hofmann will tell us how they do some GAAP calculations at Bankers Life and Casualty. I will present a novel approach of how we GAAP at Mutual of Omaha.

MR. ROBERT W. BEAL: The first objective in my presentation is to give a fairly quick review of the FASB and AICPA actions that have led to the recent flurry of activity by mutual companies to develop GAAP accounting. The second is to discuss the development of GAAP accounting pertaining to individual disability income business at my former employer.

GAAP FOR MUTUAL COMPANIES

FASB originally exempted mutual companies from *Statement of Financial Accounting Standard (SFAS) 60* in 1982, *SFAS 97* in 1987 and *SFAS 113* in 1992. *SFAS 60* extracted the specialized life insurance accounting practices from the audit guide. *SFAS 97* defined accounting standards for investment contracts, limited payment contracts and universal life-type contracts. *SFAS 113* applied new standards for reinsurance. Mutual companies were also exempt from *SFAS 12*, accounting for certain marketable securities, but this was superseded by *SFAS 115*, which did not exempt mutual companies. Mutual companies and fraternal organizations were excluded from *SFAS 60, 97* and *113* because of disagreement over the nature and purpose of financial statements for these companies and a greater urgency to get standards out for publicly traded stock companies. At the time the audit guide was published in 1972, a task force of the AICPA was formed to address the standards for mutual companies. However, these issues remained unresolved until recently.

Most mutual companies took the position that their statutory statements conformed with GAAP. For 20 years, mutual companies largely ignored all FASB statements, not just those they were specifically exempt from.

While it was drafting *SFAS 113*, FASB became aware of the position that mutual companies were taking with respect to the FASB statements and issued Interpretation 40 in 1992 in draft form and in final form in 1993. Interpretation 40 has the following effect:

- It clarifies that mutual companies are subject to all FASB statements except *SFAS 60, 97 and 113*;
- It requires mutual companies to disclose their accounting practices and methods in accordance with Actuarial Practices Bulletin (APB) Opinion No. 22;
- It does not define an accounting basis for mutual companies.

FASB has extended the effective date of Interpretation 40. It is now effective for fiscal years beginning after December 15, 1995. Statutory financial statements beginning in 1996 can no longer be described as “prepared in conformity with generally accepted accounting principles.”

At the time it originally issued Interpretation 40, FASB urged the AICPA to resurrect its task force on mutual company GAAP and to reach a quick conclusion. The AICPA responded by releasing a Statement of Position (SOP) pertaining to *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, released in March 1994 in draft form and finalized as SOP 95-1 on January 18, 1995.

SOP 95-1 applies to those enterprises that were specifically exempt from *SFAS 60, 97, and 113*, namely mutual companies, fraternal benefit societies, assessment enterprises and wholly owned stock subsidiaries of mutual insurance enterprises. The new accounting standards in SOP 95-1 apply only to long-duration participating life insurance products that are expected to pay dividends in accordance with the contribution principle. All products that do not meet this criteria, including individual health products, must follow the appropriate principles of *SFAS 60 and 97* as their GAAP accounting basis.

Concurrent with the release of SOP 95-1, FASB released *SFAS 120*, which amended *SFAS 60, 97, and 113* and Interpretation 40 by removing the mutual company exemptions and implementing the accounting standards defined by SOP 95-1. The bottom line is that if mutual companies now want to state that their financial reports were “prepared in conformity with generally accepted accounting principles,” then they must use GAAP accounting.

DEVELOPING GAAP FOR DISABILITY INCOME (DI) POLICIES

My former employer, UNUM, officially demutualized in the summer of 1986. However, GAAP financial statements were needed early in the preparation process. GAAP accounting was mostly built in 1984. At that time, I was the head of the DI actuarial department and assumed the responsibility of designing and developing the GAAP accounting methodologies and assumptions for the individual DI line of business.

There were three major GAAP components to develop: policy reserves (also known as active life reserves), deferred acquisition costs (DAC), and claim reserves.

The policy reserves consist of two types: (1) policy benefit reserves for leveling the cost of future claims and (2) maintenance expense reserves for leveling the impact of inflation on future maintenance expenses. The policy benefit reserves are the much larger component for which we spent most of our time developing assumptions. I would like to mention a few thoughts about the development of these assumptions:

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Pricing Assumptions

You may find when you develop your own GAAP reserves that the old pricing assumptions consist of some actuarial memorandums, in which the data is sketchy at best. The files of claim costs that ideally would go into the calculation of policy benefit reserves may no longer exist or are incompatible with your current equipment. That is essentially what we discovered in 1984. This required us to develop new claim cost assumptions for the old blocks of business based on experience in the prior five calendar years. It was essentially using 20/20 hindsight at that time, but it provided reasonable claim costs when we compared the resulting net and gross premiums.

Class Assumptions

Claim costs, and the resulting policy benefit reserves, were differentiated by rate book, issue age, sex (where premium rates were sex distinct), occupation class, elimination period, benefit period, specific policies, and riders.

Select and Ultimate

There has been a long-running question whether this business has a select period or not. A number of people argue that there is an antiselect period. My own experience is that in the first two years, concurrent with the contestable period, there may be significantly lower claim costs. In doing claim cost studies, there is a tendency to overlook this pattern and develop aggregate claim costs that are independent of policy duration. This can distort your financial result in the early policy years, making them look more favorable than they are. If there is some select period, your policy benefit reserves should increase at a faster rate in the early policy years, thus spreading out the impact of the favorable early experience. Also, be aware that if you first start out with an aggregate approach in developing claim costs for GAAP policy benefit reserves, but decide to switch to a select-and-ultimate approach for some later rate book, an unusual blip in your reported loss ratios could occur for several years. This would be due to the relatively high increases in policy reserves for the new business, which are not offset by smaller increases on the older business because they are reserved on the older basis.

Claim Expense

When we developed our claim costs, we also built in the cost of claim expense, in the form of a factor applied to the incidence rate and a factor applied to the present value of future benefits. Some people choose to multiply the total claim cost by some level factor to represent the claim expense. Conceptually, our approach seemed a little more refined, but it also made it difficult to break out the claim expense component from the claim cost component when we did our analysis. Consequently, the claim expense component was always a part of the change in policy reserves and our measurement of loss ratios.

Persistency

Similarly, we developed lapse rates by issue age, policy year, and occupation class rather than rely on old pricing assumptions. We did not see significant differences between rate books and thus used the same table for all the rate books.

Provision for the Risk of Adverse Deviation

This item represents one of the big unknowns. How much provision is appropriate? We used an add-on of 5–10% of claim costs with no extra provision in the policy lapse rates. Adding an extra provision to lapse rates can be tricky because what's conservative for

policy benefit reserves, that is, lower lapse rates, is not conservative for deferred acquisition costs. If you want to have some provision within the lapse rates for adverse deviation, plan to do some overall sensitivity testing to ensure that the different lapses result in a higher “net” reserve, that is, the net of the policy reserve and the DAC. Possibly, you will want to increase lapse rates for four or five years and then decrease them somewhat thereafter.

To calculate the deferred acquisition costs, we first separate them into commission costs and noncommission costs. The commission costs spread the commission rates in excess of the ultimate rates for the specific commission scales over the life of the business. Because the ultimate commission rates were in years 11 and later, there is a deferral of costs in renewal years 2–10. The noncommission costs represent the costs of the field force, underwriting, and policy issue, and were incurred in the first policy year. Let’s discuss this with regards to deferring acquisition costs.

Capping the Noncommission Costs

My company took the position that essentially all field force, underwriting, and policy issue costs were potentially deferrable acquisition costs. However, it had a standard set of expense factors to be applied to the volume of new business, which determined a cap on the amount of acquisition costs that were deferred in any year. The standard expense factors were based on the results of recoverability testing. It ensured that we did not defer more than we could recover. Over the years, the standard expense factors had been adjusted for new business.

Amortization

The acquisition costs were deferred over the life of the policies as prescribed in the audit guide. As long as a policy remained in force, there was a DAC attached to it. On average, based upon the lapse assumptions, the average amortization was 10–11 years. Some companies will limit the amortization period to, say, 20 years, either for philosophical or practical reasons.

Recoverability Testing

Ideally, every year you must demonstrate that the new acquisition costs being deferred are recoverable and thus appropriately labeled as an asset. This is based on modeling that takes your best estimate of assumptions without any provision for the risk of adverse deviation. This is straightforward unless there is a significant change in experience that your current rate book did not anticipate and that cannot be offset through adjustments in the underwriting requirements or plan offering. I always found the question of whether to include overhead in the recoverability test difficult to answer. The guidelines say that general overhead expenses do not need to be included. However, if it appears that the general overhead expenses can never be absorbed by the existing premium margins, the actuary should have some serious discussions with management regarding the implications for future profitability.

For both the policy reserves and the deferred acquisition costs, my company decided to develop reserve factors that were applied to in-force records. It was relatively easy to modify the statutory reserve systems to accommodate GAAP factors. The DAC factors were treated as negative reserves. The policy benefit reserves, maintenance expense

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reserves, commission DAC, and noncommission DAC are calculated and reported separately. The noncommission DAC is also reported by year of issue so that adjustment factors can be applied by issue year to reflect differences in the cap on deferred acquisition costs from one year to another. In retrospect, if I had the type of modeling technology that's available today, I may have tried to model the deferral of the acquisition costs instead of building factors. A model may have made financial projections a lot easier, as well as possibly made our methodologies a little more understandable to nonactuaries.

At the time GAAP was being developed, a new GAAP basis for claim reserves was also being created using a more up-to-date experience continuance table and higher interest rates than the statutory claim reserve basis. Over the years, as claim termination experience has decreased, the claim reserve bases have moved closer together, so that today they are the same.

The assumptions that go into the policy reserves and the deferred acquisition costs are "locked-in" at issue, unable to be changed unless there is a premium deficiency identified in a loss recognition test. On the other hand, the claim reserve assumptions are not locked in and may be subject to periodic adjustments. The loss recognition test should be performed on a regular basis. It essentially compares a gross premium reserve to the net of the policy reserves and the DAC. If the gross premium reserve exceeds the net GAAP reserve, the difference must be recognized immediately in the financial results. If the gross premium reserve is less than the net GAAP reserve, then the lock-in principle does not allow you to change assumptions in the reserves. Instead the positive margins must emerge over time as the reserves are released.

In 1994, as experience from our block of physicians deteriorated quickly, my company calculated a new gross premium reserve that reflected the current level of physician claims and our best guess of their course in the future. It demonstrated a significant GAAP reserve inadequacy that was recognized in the third quarter of last year. I would like to share a few thoughts about this exercise:

Modeling

The gross premium reserve was developed using a fairly sophisticated model. This model satisfied both a need for speed and a need for flexibility. It would have been impossible to build reserve factors that reflected the assumed secular changes in underlying claim costs. A good model will give you that flexibility.

Increase Reserves or Decrease DAC

I had been under the assumption that for loss recognition, when an inadequacy must be recognized, there was some kind of pecking order: first the DAC, then the reserves. I think it was based upon some earlier study notes or the old Ernst & Ernst GAAP Book. However, the audit guide does not specify any such order. The amount of loss recognition is not affected by whether it's called a reserve strengthening or a DAC reduction. In later years, the impact of the loss recognition can give different results depending upon whether it is treated as a reserve strengthening or a DAC reduction. We chose to call it a reserve strengthening and modeled the pattern of additional reserves needed in the future. Reducing the DAC would have given an inappropriate pattern of future earnings. In closing, I would like to discuss a few financial reporting issues, or specifically, what are you going to do with GAAP results once you have them?

Understanding GAAP

Management will need considerable training to understand how GAAP is different and how it's similar to statutory. You will see loss ratios different than those shown in statutory results, and, depending on your assumptions, it's possible that the GAAP loss ratios will be higher than the statutory loss ratios. After all, GAAP policy reserves are calculated on a net level premium reserve basis. This will take some explaining. Management may also ask why the GAAP loss ratio is not close to the 50% pricing assumption. In this case, the discussion would normally get into the necessity of showing interest-adjusted reserve changes. Depending upon the financial backgrounds of your management, the concept of interest adjustments may be difficult to understand.

Too Much Attention to GAAP, Too Little to Statutory

GAAP will take up most of your time and resources, as well as the attention of management. It could be that no one is paying close attention to the statutory side. Strong sales growth can improve the GAAP picture but dampen statutory income. Statutory-based income statements and balance sheets are still critical, in spite of all the attention directed to GAAP. A well-run financial organization pays close attention to both.

Measuring Profits

Your company must decide how it plans to measure profits and set financial objectives. Will profits be measured solely by GAAP net income before or after tax, or perhaps, by the year-over-year growth in GAAP net income? Possibly your company wants to measure a return on capital. In this case you need a clear definition of GAAP capital, how it is allocated to the different business units, and a strategy for managing GAAP capital. If the profit objective is in the form of a specified return on capital, you may find that being too aggressive in deferring expenses will ultimately work against you as the GAAP capital, of which DAC is a major component, grows faster than the net income.

For those of you who have never had GAAP in your companies, I would like to say welcome. If done well, GAAP accounting can provide excellent insight into the nature of the business. However, it will take much effort and resources, and the transition period may try your patience.

MR. SHAPLAND: Helen will tell us how they did it at Bankers Life and Casualty.

MS. HELEN HOFMANN: Bankers is a stock company. We first began doing GAAP financial statements in the early 1980s. At that time we were owned by the MacArthur Foundation and were preparing for the sale of the company. When we were sold in 1984, we were prepared for reporting our results to the public.

I am focusing on individual health business. We have sold four major types of health business: Medicare supplement, long-term care, comprehensive major medical, and what we call "other," which is everything else.

First, I will cover our methodology, including factor development, the application of factors, and adjustments made. Then I will cover the types of factors we carry for the assets and reserves. Finally I will go over an example.

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Issues for GAAP Unique to Health Business

There are three major issues I have found that are unique to health insurance in our company. The first is, how do you handle the benefit and the premium increases? Second, we have had to deal with the fact that the actual commissions often are different from those assumed in the model. The third is the impact of the persistency assumption. I will talk about how we handle each of these three issues at our company in the course of my presentation. Then I will review these issues one more time at the end.

METHODOLOGY

Blocks of Business

We calculate reserves by issue period, plan category, and underwriting category. Several issue years may use the same factors, but the results are calculated and carried separately by issue year and duration. Commission scales may be changed during the year, so we develop new factors for each issue period, that is, we may have one set of factors for issues of January 1, 1993 to July 30, 1994, and another for issues of August 1, 1994 and later.

Plan category is any new policy form which is separately priced by our product area. We aggregate, using an average weighted assumption, all issue ages. If a state version has characteristics unique enough to carry a separate plan code, we carry separate factors. Otherwise, we use weighted average assumptions to account for unique state versions.

Underwriting category reflects whether the policy is guarantee issue or underwritten. For reserves, the claim cost curve is quite different on these two blocks of business.

Assumptions

We use pricing assumptions. The input is a set of asset shares we get from our pricing department. The only way in which assumptions are different from pricing is that we do not include future rate and benefit increases in developing our factors initially. This adds an element of conservatism.

Factors Versus Model

Historically, we have used the factor method. My discussion and the example later will be based on the factor method. Under the model or "worksheet method," all policies in a cell are projected, and that projection is generally used for all future financial statements without adjustments for changes to in force due to persistency.

Persistency can have quite different impacts on results depending on which methodology is used as well as the characteristics of the business. If the factor method is used, the impact of persistency will be similar on both the asset and the reserves. Better persistency than that assumed when developing the factors will result in retaining both the asset and the reserves. Thus, the positive income effect on the asset will be at least partially offset by the effect on the reserves.

The second key factor is whether or not there are nonforfeiture values. On much of the life and annuity business, there will be nonforfeiture values paid out which partially offset the release of the reserve. But, on the health business, that is often not the case. So the net impact is a result of the size of the asset, the size of the reserve, and whether there's a nonforfeiture payment to offset the reserve. For example, on our Medicare supplement, the asset is greater than the reserve. So, when persistency is good, we retain more of the

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asset, and the short-term financial results are better than expected. Our long-term care business has a higher reserve than asset. On those plans without nonforfeiture values, the short-term impact of good persistency is a negative financial result.

If the worksheet method is used for the asset but factors for the reserves, actual persistency will impact the reserves but not the asset.

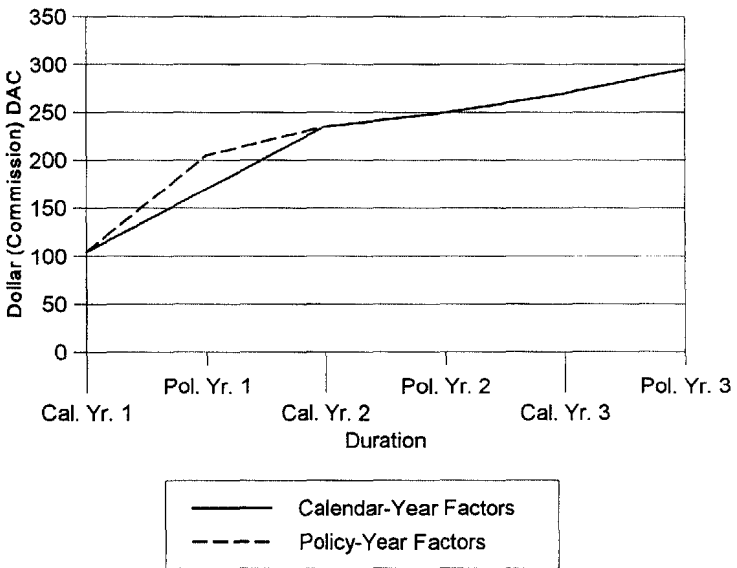
Factors

We develop factors per policy, not per dollar of premium.

We also use policy-year factors. I will contrast this with calendar-year factors, which are interpolated policy-year factors.

Calendar-year factors will distort results (unless further adjusted). They work reasonably well on reserves that have a consistent trend from period to period. However, they do not work well on the DAC asset. Chart 1 illustrates what happens. Because most costs are deferred during the first year, the increase in DAC is much higher during the first policy year, and much lower the second year. This pattern gets smoothed out incorrectly when factors are interpolated. We use policy-year factors and apply them by month of issue. That way we can best relate the DAC to actual expenses deferred.

CHART 1
POLICY VERSUS CALENDAR-YEAR FACTORS



Premium and Benefit Increases

On our Medicare supplement and comprehensive major medical business there will be premium increases due to aging on products which are not level premium rated. These increases are projected. However, increases for benefit inflation are not known at the time the factors are created. Likewise, corrective action for higher than expected benefits is an

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unknown when the factors are created. If these amounts are projected using an assumption, the actual results can be very far off. For example, benefit inflation can vary from 5% to 25% per year. Consequently, we do not project increases for benefit inflation or corrective action when developing our factors.

However, benefit reserves are adjusted every year. We use what we call benefit increments. Each increase in benefit is treated as an additional benefit with a new issue year and reserved for as a separate piece. We do not adjust the DAC asset for inflation or corrective action. This is conservative since additional premium would allow us to slow down the amortization of the DAC.

Actual-to-Expected Ratios

Because we use factors on a per policy basis, the assumption for the average premium at issue is very critical. Actual premium can be very different. This is particularly true if the same factors are used for several issue years and benefit inflation has been high. This can cause, for example, the average premium for 1994 issues to be much higher than 1991 issues. To adjust for this assumption, we develop “actual-to-expected” ratios and apply them to our factors. The actual to expected ratio is locked in at the end of the first year.

Commission Reconciliation

We develop a number at the end of each quarter that tells us the commissions assumed as the result of the application of all the various factors. The “assumed commissions” have been further adjusted for average size at issue by the “actual-to-expected” ratios. Actual commissions are compared to assumed commissions and the resulting ratio applied to obtain our final DAC.

ASSETS

Equity in Unearned Premium

All of the DAC asset is set up on an earned basis. Commissions paid but not yet earned are carried as equity in unearned premium. For example, assume a full year’s commission of \$120 has been paid on December 1. On December 31, equity in unearned premium is \$110. The other \$10 has been capitalized in the DAC.

DEFERRED ACQUISITION COSTS

Per Policy

We use this factor for expenses incurred at issue, that is, issue/underwriting expense, certain field office expenses, and some elements of compensation.

Per Dollar

This factor is used for commissions and overrides.

RESERVES

Active Life Reserves

For GAAP, these reserves are calculated based on claim costs reflecting the impact of selection. We have Medicare supplement and comprehensive major medical business which is not level premium rated but for which we carry active life reserves. These reserves level out the impact of the claim cost curve.

CLAIM RESERVES

This is the reserve for amounts not yet due, carried on long-term care and disability income. The only difference between statutory and GAAP reserves on our claim reserves is the interest rate. For GAAP reserves we use a current interest rate, whereas for statutory we use 3.5% interest since we are an Illinois domiciled company. The difference in interest rate makes a significant difference in the level of this reserve on a statutory versus GAAP basis.

Expense Reserves

These reserves are carried to level out expenses. We carry both a claim expense reserve and an administrative expense reserve (for maintenance expenses).

Both the claim expense and the administrative expense reserve reflect higher future expenses due to inflation. However, inflation is applied only on those lines of business for which there are not benefit increases due to inflation. Consequently, we adjust for inflation on the long-term care and other lines of business, but we do not adjust for inflation on the Medicare supplement and comprehensive major medical lines. We assume the premium increase also covers any increase in expenses due to inflation.

The claim expense reserve also reserves for the increased expense handling required as claims increase into the future. On long-term care, this is a substantial reserve since we assume both increases due to the claim level as well as inflation.

Example of Factor Development

Now I will go over an example of our asset and reserve factor development. See Tables 1A-F. The methodology is very similar to any other reserve factor development.

Assumptions

Tables 1A and B show a projection of premiums, claims and expenses by policy year. Specifically, we have earned premium, commissions, claim expense (expense of paying a claim, not the claim cost itself), number of policies in force, interest rate (the projected earned rate), inflation rate (which will be used for calculating expense reserves), incurred claims, administrative expense (that is, maintenance expense), and percentage of policies issued and paid for that are still in force at the end of the policy year. As I mentioned earlier, these projections come directly from the asset share.

In Table 1C we also produce these projected costs as a percentage of premium. This is very helpful for analytical purposes.

Present Values

Table 1D shows the present value at duration zero, which is the present value at issue of all future claims, premiums, and so on.

Net to Gross Ratios and Reserve Factors

Factors for the assets are shown as negative reserves in Table 1E. These factors are simply the present values divided by the number of policies. Note that we show the assumed commission expense here to be used in the commission reconciliation I discussed earlier.

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The "policy DAC" is based on \$10 of acquisition expense at issue. The remainder of the assets and reserves are calculated based on the present value of future benefits and premiums, and respective net premiums.

The only difference between Table 1E and Table 1F is that Table 1E is policy-year factors (which we use now) and Table 1F is calendar-year factors.

**TABLE 1A
GAAP FACTOR DEVELOPMENT**

Policy Year	Earned Premium	Commissions	Claim Expenses	Policies In force
1	85,796,934.7165	27,101,432.7819	1,946,024.2920	79,352.3804
2	70,894,427.5384	8,237,195.1778	1,864,971.6934	66,164.0886
3	58,818,730.2797	6,037,542.6795	1,759,421.1793	55,659.7916
4	49,221,555.4735	4,726,017.4931	1,807,666.0107	47,217.5681
5	41,528,445.8547	3,355,124.6690	1,816,891.1214	40,375.9833
6	35,310,266.8964	2,229,433.7554	1,585,231.8007	34,479.3889
7	29,975,877.9353	1,131,097.7876	1,375,186.4606	29,392.5684
8	25,398,828.3456	842,148.9514	1,190,684.6767	25,000.8278
9	21,468,826.6855	643,665.4804	1,031,883.4153	21,207.7522
10	18,094,786.5644	485,045.2297	888,036.1886	17,933.3693
11	15,200,844.4832	342,161.8888	763,529.5530	15,077.5132
12	12,694,641.9980	285,748.7746	651,231.4371	12,599.2654
13	10,536,199.0442	237,163.5188	551,897.3578	10,459.6776
14	8,685,858.8660	195,513.4715	465,007.8099	8,621.5934
15	7,107,410.3852	159,983.5433	387,894.6469	7,050.4937
16	5,767,942.4230	129,832.9232	321,016.2716	5,714.9036
17	4,637,628.4074	104,390.2329	263,086.9196	4,586.5152
18	3,690,789.0791	83,077.4477	213,533.8639	3,640.1286
19	2,903,610.4781	65,358.5297	171,490.0704	2,853.4109
20	2,255,296.3293	50,765.3672	134,431.4592	2,206.3715
21	1,727,204.5273	38,878.3376	103,892.3057	1,680.6993
22	1,302,653.1959	29,321.9418	79,070.0437	1,259.5931
23	966,244.2432	21,749.5782	59,178.5974	928.1008
24	703,756.1947	15,841.1297	43,486.1303	672.4601
25	505,206.2083	11,371.8886	31,479.3417	477.6466
26	354,033.4978	7,969.0816	22,249.7336	330.5812
27	241,224.0222	5,429.8080	15,302.7742	221.9974
28	159,261.1189	3,584.8722	10,197.3504	144.2589
29	100,947.3907	2,272.2652	6,523.1537	90.8120
30	62,715.6207	1,411.6910	4,080.0851	54.2425
31	35,833.4222	806.5888	2,346.9180	28.8484
32	17,583.5093	395.7942	1,169.1105	12.1253
33	6,348.5497	142.9020	428.7068	2.8222
Premiums at Issues = 8,203,600.40 Policies In force at Issue = 100,000.00 Average Premium at Issue = 82.04				

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TABLE 1B
GAAP FACTOR DEVELOPMENT
ASSUMPTIONS

Policy Year	Interest Rate	Inflation Rate	Claims	Assumptions	
				Administration Expense	In force Percentage
1	0.0900	0.0000	30,406,629.5624	3,082,258.5681	0.7935
2	0.0880	0.0000	29,140,182.7097	2,836,406.6658	0.6616
3	0.0860	0.0000	27,490,955.9272	2,594,040.0800	0.5566
4	0.0840	0.0000	28,244,781.4167	2,524,151.8219	0.4722
5	0.0820	0.0000	28,388,923.7713	2,437,502.0576	0.4038
6	0.0800	0.0000	24,769,246.8864	2,137,492.6098	0.3448
7	0.0780	0.0000	21,487,288.4474	1,866,107.3843	0.2939
8	0.0760	0.0000	18,604,448.0734	1,626,203.0818	0.2500
9	0.0740	0.0000	16,123,178.3636	1,417,118.6715	0.2121
10	0.0720	0.0000	13,875,565.4474	1,227,954.3093	0.1793
11	0.0700	0.0000	11,930,149.2654	1,062,353.5565	0.1508
12	0.0680	0.0000	10,175,491.2049	912,421.4490	0.1260
13	0.0660	0.0000	8,623,396.2158	778,754.7926	0.1046
14	0.0640	0.0000	7,265,747.0290	660,672.0167	0.0862
15	0.0620	0.0000	6,060,853.8581	555,430.6141	0.0705
16	0.0600	0.0000	5,015,879.2438	463,260.4182	0.0571
17	0.0600	0.0000	4,110,733.1187	382,726.2239	0.0459
18	0.0600	0.0000	3,336,466.6235	313,102.9890	0.0364
19	0.0600	0.0000	2,679,532.3499	253,378.4775	0.0285
20	0.0600	0.0000	2,100,491.5503	200,980.5443	0.0221
21	0.0600	0.0000	1,623,317.2765	154,968.2972	0.0168
22	0.0600	0.0000	1,235,469.4325	117,670.8249	0.0126
23	0.0600	0.0000	924,665.5838	87,870.4192	0.0093
24	0.0600	0.0000	679,470.7861	64,428.5331	0.0067
25	0.0600	0.0000	491,864.7136	46,531.8236	0.0048
26	0.0600	0.0000	347,652.0873	32,814.8069	0.0033
27	0.0600	0.0000	239,105.8475	22,516.2839	0.0022
28	0.0600	0.0000	159,333.6004	14,972.0691	0.0014
29	0.0600	0.0000	101,924.2762	9,559.5236	0.0009
30	0.0600	0.0000	63,751.3301	5,965.2054	0.0005
31	0.0600	0.0000	36,670.5937	3,423.2708	0.0003
32	0.0600	0.0000	18,267.3522	1,696.4592	0.0001
33	0.0600	0.0000	6,698.5443	618.7975	0.0000

HEALTH GAAP TOPICS

TABLE 1C
GAAP FACTOR DEVELOPMENT
COSTS AS A PERCENTAGE OF PREMIUM

Policy Year	Claims	Commissions	Claim Expense	Administration Expense
1	35.44	31.59	2.27	3.59
2	41.10	11.62	2.63	4.00
3	46.74	10.26	2.99	4.41
4	57.38	9.60	3.67	5.13
5	68.36	8.08	4.38	5.87
6	70.15	6.31	4.49	6.05
7	71.68	3.77	4.59	6.23
8	73.25	3.32	4.69	6.40
9	75.10	3.00	4.81	6.60
10	76.68	2.68	4.91	6.79
11	78.48	2.25	5.02	6.99
12	80.16	2.25	5.13	7.19
13	81.85	2.25	5.24	7.39
14	83.65	2.25	5.35	7.61
15	85.28	2.25	5.46	7.81
16	86.96	2.25	5.57	8.03
17	88.64	2.25	5.67	8.25
18	90.40	2.25	5.79	8.48
19	92.28	2.25	5.91	8.73
20	93.14	2.25	5.96	8.91
21	93.99	2.25	6.02	8.97
22	94.84	2.25	6.07	9.03
23	95.70	2.25	6.12	9.09
24	96.55	2.25	6.18	9.15
25	97.36	2.25	6.23	9.21
26	98.20	2.25	6.28	9.27
27	99.12	2.25	6.34	9.33
28	100.05	2.25	6.40	9.40
29	100.97	2.25	6.46	9.47
30	101.65	2.25	6.51	9.51
31	102.34	2.25	6.55	9.55
32	103.89	2.25	6.65	9.65
33	105.51	2.25	6.75	9.75

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TABLE 1D
GAAP FACTOR DEVELOPMENT
PRESENT VALUES

Policy Duration	Present Value Future Claims	Present Value Future Premiums	Present Value Future Comms	Present Value Administration Expense	Present Value Claim Expense
0	195,075,954.42	359,861,794.83	47,679,526.84	17,951,290.55	12,484,861.08
1	180,887,337.06	302,674,726.77	23,675,957.75	16,348,934.28	11,576,789.57
2	166,410,102.85	255,362,083.12	17,167,451.21	14,829,063.03	10,650,246.58
3	152,072,682.61	216,027,444.82	12,352,048.87	13,401,078.94	9,732,651.69
4	135,439,643.20	182,926,569.87	8,469,112.70	11,898,740.81	8,668,137.16
5	117,015,754.32	154,728,979.40	5,673,605.13	10,338,966.71	7,489,008.28
6	100,636,058.22	130,411,791.98	3,810,598.02	8,944,736.56	6,440,707.73
7	86,176,111.31	109,460,923.27	2,933,442.27	7,704,906.83	5,515,271.12
8	73,427,023.67	91,433,642.16	2,282,819.24	6,603,612.46	4,699,329.52
9	62,151,533.39	75,950,734.01	1,784,691.77	5,623,663.43	3,977,698.14
10	52,260,039.54	62,684,309.37	1,410,986.19	4,757,174.83	3,344,642.53
11	43,577,599.95	51,348,335.23	1,155,820.22	3,991,270.00	2,788,966.40
12	36,025,108.42	41,720,860.34	939,111.53	3,319,742.76	2,305,606.94
13	29,499,343.88	33,596,098.62	756,228.02	2,734,802.67	1,887,958.01
14	23,892,656.54	26,786,752.88	602,953.74	2,228,344.37	1,529,130.02
15	19,128,086.23	21,123,104.63	475,468.41	1,794,111.68	1,224,197.52
16	15,111,607.65	16,452,030.72	370,325.34	1,424,802.59	967,142.89
17	11,786,045.33	12,664,421.88	285,068.54	1,116,249.98	754,306.90
18	9,058,105.42	9,624,387.27	216,639.18	860,865.72	579,718.75
19	6,842,844.34	7,212,400.55	162,346.81	651,648.56	437,942.04
20	5,090,826.59	5,323,174.89	119,821.47	483,825.33	325,812.90
21	3,724,968.76	3,864,299.49	86,983.06	353,305.23	238,398.00
22	2,676,473.25	2,754,993.91	62,013.26	253,354.01	171,294.29
23	1,885,060.16	1,925,484.21	43,341.49	178,087.12	120,643.85
24	1,298,605.78	1,316,451.91	29,632.54	122,439.11	83,110.77
25	870,116.41	875,297.40	19,702.42	81,878.01	55,687.45
26	564,393.66	563,315.45	12,679.89	53,005.78	36,121.19
27	352,082.74	348,759.04	7,850.36	33,004.20	22,533.30
28	209,163.72	205,715.23	4,630.53	19,569.76	13,386.48
29	116,776.08	114,126.44	2,568.92	10,901.81	7,473.67
30	58,146.64	56,404.34	1,269.63	5,414.37	3,721.38
31	23,880.75	22,895.84	515.37	2,214.76	1,528.37
32	6,506.20	6,166.26	138.80	601.03	416.40
33	0.00	0.00	0.00	0.00	0.00

HEALTH GAAP TOPICS

TABLE 1E
GAAP FACTOR DEVELOPMENT
NET TO GROSS RATIOS AND RESERVE FACTORS

Policy Duration	Benefit Reserve	Policy DAC	Dollar DAC	Administrative Expense Reserve	Claim Expense Reserve	Commission Expense
1	211.86	-10.60	-207.01	0.00	13.56	341.53
2	422.92	-10.73	-251.90	0.00	27.07	124.50
3	628.23	-10.79	-292.32	0.00	40.21	108.47
4	768.31	-10.77	-333.93	0.00	49.17	100.09
5	820.77	-10.65	-367.22	0.00	52.53	83.10
6	868.39	-10.51	-390.62	0.00	55.58	64.66
7	913.12	-10.35	-393.62	0.00	58.44	38.48
8	954.45	-10.16	-393.25	0.00	61.09	33.68
9	989.25	-9.95	-390.34	0.00	63.31	30.35
10	1,019.32	-9.71	-384.44	0.00	65.24	27.05
11	1,044.10	-9.46	-374.57	0.00	66.82	22.69
12	1,064.25	-9.20	-364.20	0.00	68.11	22.68
13	1,079.13	-8.93	-353.27	0.00	69.06	22.67
14	1,087.03	-8.63	-341.72	0.00	69.57	22.68
15	1,088.94	-8.33	-329.51	0.00	69.69	22.69
16	1,083.69	-8.00	-316.62	0.00	69.36	22.72
17	1,072.89	-7.67	-303.69	0.00	68.67	22.76
18	1,055.14	-7.35	-290.80	0.00	67.53	22.82
19	1,027.93	-7.02	-278.00	0.00	65.79	22.91
20	999.47	-6.70	-265.35	0.00	63.97	23.01
21	969.95	-6.39	-252.88	0.00	62.08	23.13
22	939.22	-6.08	-240.56	0.00	60.11	23.28
23	906.46	-5.77	-228.18	0.00	58.01	23.43
24	869.90	-5.44	-215.31	0.00	55.67	23.56
25	828.29	-5.09	-201.55	0.00	53.01	23.81
26	783.55	-4.74	-187.42	0.00	50.15	24.11
27	734.36	-4.37	-172.79	0.00	47.00	24.46
28	676.90	-3.96	-156.84	0.00	43.32	24.85
29	604.65	-3.49	-138.22	0.00	38.70	25.02
30	508.28	-2.89	-114.37	0.00	32.53	26.03
31	397.57	-2.21	-87.29	0.00	25.44	27.96
32	260.91	-1.41	-55.93	0.00	16.70	32.64
33	0.00	0.00	0.00	0.00	0.00	50.63
Benefit Reserve	0.542086					
Policy DAC	0.000278					
Administration Reserve	0.049884					
Dollar DAC	0.132494					
Claim Expense	0.034693					

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CHART 1F
GAAP FACTOR DEVELOPMENT
NET TO GROSS RATIOS AND RESERVE FACTORS

Calendar Duration	Benefit Reserve	Policy DAC	Dollar DAC	Administrative Expense Reserve	Claim Expense Reserve	Commission Expense
1	105.93	-10.30	-103.50	0.00	6.78	170.77
2	317.39	-10.66	-229.45	0.00	20.31	233.01
3	525.57	-10.76	-272.11	0.00	33.64	116.48
4	698.27	-10.78	-313.13	0.00	44.69	104.28
5	794.54	-10.71	-350.58	0.00	50.85	91.59
6	844.58	-10.58	-378.92	0.00	54.05	73.88
7	890.76	-10.43	-392.12	0.00	57.01	51.57
8	933.79	-10.26	-393.43	0.00	59.76	36.08
9	971.85	-10.06	-391.80	0.00	62.20	32.02
10	1,004.28	-9.83	-387.39	0.00	64.27	28.70
11	1,031.71	-9.59	-379.50	0.00	66.03	24.87
12	1,054.18	-9.33	-369.38	0.00	67.47	22.69
13	1,071.69	-9.06	-358.73	0.00	68.59	22.68
14	1,083.08	-8.78	-347.49	0.00	69.32	22.68
15	1,087.98	-8.48	-335.61	0.00	69.63	22.68
16	1,086.32	-8.16	-323.07	0.00	69.52	22.70
17	1,078.29	-7.84	-310.16	0.00	69.01	22.74
18	1,064.02	-7.51	-297.24	0.00	68.10	22.79
19	1,041.54	-7.19	-284.40	0.00	66.66	22.86
20	1,013.70	-6.86	-271.68	0.00	64.88	22.96
21	984.71	-6.55	-259.12	0.00	63.02	23.07
22	954.58	-6.23	-246.72	0.00	61.09	23.21
23	922.84	-5.92	-234.37	0.00	59.06	23.36
24	888.18	-5.60	-221.75	0.00	56.84	23.50
25	849.10	-5.27	-208.43	0.00	54.34	23.68
26	805.92	-4.91	-194.48	0.00	51.58	23.96
27	758.96	-4.55	-180.10	0.00	48.57	24.28
28	705.63	-4.16	-164.81	0.00	45.16	24.65
29	640.78	-3.73	-147.53	0.00	41.01	24.94
30	556.47	-3.19	-126.29	0.00	35.61	25.52
31	452.93	-2.55	-100.83	0.00	28.99	26.99
32	329.24	-1.81	-71.61	0.00	21.07	30.30
33	130.45	-0.71	-27.97	0.00	8.35	41.64
Benefit Reserve	0.542086					
Policy DAC	0.000278					
Administration Reserve	0.049884					
Dollar DAC	0.132494					
Claim Expense	0.034693					

Summary

Let's and review the original issues unique to GAAPing health insurance that I mentioned at the beginning of my presentation.

HEALTH GAAP TOPICS

Handling of Rate and Benefit Increases

Actual results can be very different from projected rates due to benefit and rate increases. We do not attempt to project these increases when the factors are initially developed. We adjust reserves but not the assets for subsequent changes.

Reconciliation of Assumed-to-Actual Commissions

We do a reconciliation of actual versus assumed commissions and adjust the DAC accordingly.

Persistency Assumption

Actual persistency that is different from assumed persistency can have various financial effects, depending on the size of the asset relative to the reserve, whether there are nonforfeiture values and whether the factor or worksheet method is used.

MR. SHAPLAND: My discussion covers Mutual of Omaha's approach to GAAP for its individual health business. This is a new process for us, as we have not yet finalized any GAAP reports.

Given that the purpose of GAAP is to level out the cost of DAC and claims as a percentage of premiums over the life of our policies, we were faced with recognizing that premium sizes and claim costs per premium dollar change over the years due to the implementation of premium increases that cover increases in morbidity costs. These premium increases can be implemented every year on some forms to cover increases in medical care costs, or might be implemented sporadically to counter deterioration in disability or other morbidity costs.

Our response to this premium forecasting problem was to adopt calculations which utilize premium persistency instead of policy persistency. In this regard, we know from past studies of aggregate policy form statistics that premium persistency by policy form is highly predictable because it is somewhat independent of premium increase activity. This is because premium increases create nearly an offsetting amount of extra policy lapsation, leaving the premium revenue stream little affected. Accordingly, we adopted persistency tables by policy form groups which reflect the expected flow of earned premiums each calendar year for each group of policies with the same calendar-year effective dates. This approach is consistent with the way we have historically tabulated and analyzed our experience.

Similarly, historical studies have shown that downstream claim costs per policy are affected by premium increases, while durational loss ratios are quite predictable under our scenario where we have followed consistent renewal rating practices for many years. Thus, benefit reserves are based on assumed durational loss ratios for each issue-year block. This approach called for setting up valuation groups of policy forms with consistent benefits, rate increase histories, and rate book eras. Here, we ended up with approximately 90 valuation groups.

Based on studies of our historical experience under each valuation group, we adopted assumed durational persistency and loss ratios for each of them. We went on the premise that such studies in the past would have produced similar results. These assumptions were combined with interest and durational DAC cost ratios to produce durational valuation

factors for each issue year. These valuation factors are in the form of ratios of calculated benefit reserve and UDAC values to earned premiums as of each calendar year-end. Table 2 shows the derivation for one valuation group.

PERSISTENCY

The first persistency ratio is greater than 100% because the premiums earned in the calendar year of issue represent approximately one half year of coverage. DAC ratios to premiums were obtained via expense allocation and were split between marketing expenses and underwriting/issue expenses because marketing expenses are high during the first “policy” year which encompasses the first two “calendar” years while underwriting/issue expenses take place at the time of issue.

Calendar year-end benefit reserves and UDAC are calculated by: (1) generating the stream of premiums with a first calendar year radix of \$1, claims, and DAC expenses; (2) calculating their present values at issue; (3) calculating the resulting valuation premium relativities; and (4) accumulating the difference between the valuation premiums and costs. GAAP values each year are divided by the related earned premiums in deriving valuation ratios. These are applied to the actual earned premiums in producing benefit reserves and UDAC. This means, for example, that persistency lower than expected creates lower financial statement values consistent with prospective valuation.

Our valuation methodology lends itself to measuring actual to expected persistency and loss ratios that are useful in examining “loss recognition” and producing source of earnings reports. For example, the impact of persistency, different than expected on benefit reserves and UDAC, can be easily calculated and reported under source of earnings reporting.

Other Actuarial GAAP Valuation Items Include:

1. Commission paid in advance and/or related to unearned premiums.
2. Field marketing expenses related to unearned and deferred first policy-year premiums—since these expenses are allocated to first policy-year premiums.
3. The recognition of second calendar-year DAC stemming from late issues (for example, policies physically issued in 1994 with 1993 coverage effective dates).
4. Deferred DAC related to early issues (for example, policies physically issued in 1994 with 1995 coverage effective dates).

MR. ROBERT E. OREAN: I have two questions. One is, have you included product development costs in your DAC? The second question I have has to do with older blocks of business, like Medicare supplement which Bankers has. For example there was a 60% or 65% loss ratio you were required to have by state, but the state didn’t allow you to use active life reserves in your premium rate increases. As a result, your loss ratio got up to your 60–65% faster than you had expected. And, our lifetime loss ratio now is 60–65%. We’ve kept it there for four years, and we anticipate keeping our loss ratio at 60–65% in the future, yet we’re still holding a policy reserve on that. I wonder if that makes sense? And so, we also have one, old, long-term care policy that had the three- day hospital stay on which, we also have hit our lifetime loss ratio, and we have a large amount of policy reserve. I’ve been asked recently to look at that, and I ask myself if that makes sense to hold such a big reserve on something that we’ve already hit our loss ratio on, and that we plan on having rate increases every year to continue to keep it there.

TABLE 2
DERIVATION FOR ONE VALUATION GROUP

Issue Yr.	1991	Major Medical	Cal. Yr	Deduct.	Loss Adj. Expense	Loss Adjust. Expense 8.5%	Market	ing/Under	Costs:									
Calendar Year	1991	Perst.	Earned	Interest	Loss	Padded	Discounted	Discounted	Benefit	Benefit	Discounted	UDAC	UDAC	Actual	Benefit	UDAC		
Duration		Premiums	less P&A	Ratio	Claims & Loss	Adj Expense	Premiums	Claims & Loss	Reserve	Reserve	Mktg. & Un	Ratio	Ratio	Earned	Reserves			
									Factor	Factor	Cost			Premiums	Premiums			
1	1.78	1.00000	0.0666	0.38	0.43292	1.00000	0.43292	0.3461	0.34610	0.73441	0.56194	0.56194	0.56194	67,097,789	23,222,838	37,898,440		
2	0.77	1.75000	0.0668	0.64	1.27698	1.64088	1.19640	0.4393	0.26106	0.48329	0.78720	0.44883	0.44883	101,449,353	25,466,968	45,834,716		
3	0.90	1.34760	0.0651	0.71	1.08995	1.18549	0.96890	0.4113	0.30626	0.09227	0.64361	0.47768	0.47768	68,917,450	21,037,352	32,911,921		
4	0.82	1.07800	0.0644	0.72	0.88424	0.89044	0.73040	0.3799	0.38240	0.04482	0.52905	0.49077	0.49077					
5	0.82	0.88396	0.0636	0.73	0.73516	0.68601	0.67062	0.3462	0.39168	0.03430	0.43494	0.49204	0.49204					
6	0.82	0.72486	0.0629	0.74	0.61108	0.52987	0.44588	0.3121	0.43058	0.02644	0.36768	0.49351	0.49351					
7	0.82	0.69437	0.0622	0.75	0.50798	0.40799	0.34960	0.2787	0.46892	0.02040	0.29397	0.49458	0.49458					
8	0.82	0.48739	0.0616	0.76	0.42189	0.31496	0.27270	0.2469	0.60660	0.01675	0.24167	0.49686	0.49686					
9	0.82	0.39966	0.0608	0.77	0.35059	0.24330	0.21343	0.2170	0.64302	0.01216	0.19867	0.49710	0.49710					
10	0.82	0.32772	0.0601	0.78	0.29122	0.18907	0.16712	0.1896	0.67612	0.00840	0.16332	0.49836	0.49836					
11	0.82	0.26973	0.0594	0.79	0.24188	0.14548	0.13093	0.1643	0.61133	0.00727	0.13426	0.49957	0.49957					
12	0.82	0.22036	0.0587	0.80	0.20083	0.11260	0.10283	0.1416	0.64203	0.00663	0.11036	0.50078	0.50078					
13	0.82	0.18068	0.0580	0.81	0.16674	0.08722	0.08048	0.1210	0.66946	0.00436	0.09069	0.50192	0.50192					
14	0.82	0.14817	0.0572	0.82	0.13842	0.06780	0.06316	0.1026	0.69281	0.00338	0.07463	0.50302	0.50302					
15	0.82	0.12160	0.0566	0.83	0.11499	0.05243	0.04958	0.0963	0.71022	0.00262	0.06124	0.50406	0.50406					
16	0.82	0.09963	0.0560	0.84	0.09634	0.04068	0.03894	0.0718	0.72066	0.00203	0.05031	0.50500	0.50500					
17	0.82	0.08170	0.0554	0.85	0.07911	0.03181	0.03061	0.0590	0.72184	0.00166	0.04132	0.50683	0.50683					
18	0.82	0.06889	0.0548	0.85	0.06487	0.02486	0.02378	0.0484	0.72280	0.00123	0.03383	0.50866	0.50866					
19	0.82	0.05483	0.0537	0.85	0.05319	0.01910	0.01850	0.0397	0.72348	0.00096	0.02796	0.50986	0.50986					
20	0.82	0.04504	0.0530	0.85	0.04362	0.01487	0.01440	0.0326	0.72379	0.00074	0.02286	0.50720	0.50720					
38	0.82	0.00127	0.0523	0.85	0.00123	0.00017	0.00016	0.0008	0.69886	0.00001	0.00063	0.41964	0.41964					
39	0.82	0.00104	0.0523	0.85	0.00100	0.00013	0.00013	0.0008	0.66299	0.00001	0.00041	0.39481	0.39481					
40	0.82	0.00086	0.0523	0.85	0.00082	0.00010	0.00010	0.0004	0.61697	0.00001	0.00031	0.36227	0.36227					
41	0.82	0.00070	0.0523	0.85	0.00068	0.00008	0.00008	0.0003	0.45782	0.00000	0.00022	0.32089	0.32089					
42	0.82	0.00067	0.0523	0.85	0.00066	0.00006	0.00006	0.0002	0.36214	0.00000	0.00016	0.28779	0.28779					
43	0.82	0.00047	0.0523	0.85	0.00046	0.00005	0.00005	0.0001	0.28480	0.00000	0.00009	0.19868	0.19868					
44	0.82	0.00038	0.0523	0.85	0.00037	0.00004	0.00004	0.0001	0.16012	0.00000	0.00004	0.11221	0.11221					
45	0.82	0.00032	0.0523	0.85	0.00031	0.00003	0.00003	0.0000	0.00000	0.00000	-0.00000	-0.00000	-0.00000					
SUMMATION						7.735	5.941			1.472								
NET LEVEL PREMIUMS							76.81%			19.04%								

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MR. SHAPLAND: I guess we can all just mention what we do with product development expense. I can just say, my company does not DAC that, nor does it DAC any home office marketing costs. It only DACs field marketing costs.

MR. BEAL: We do not DAC any product development costs, or home office marketing, for that matter.

MS. HOFMANN: We don't DAC our product development costs.

MR. SHAPLAND: As far as Medicare supplement, I guess right off the top of my head, I would say the regulation doesn't prohibit you from going through these durational loss ratios, except that the loss ratio after the third year has to be 65%. If the loss ratios that I assume in my calculations reached 65% or more after the third year, the question you raised wouldn't be pertinent. I think that might be the case for my company—the loss ratios are low enough in the early years, and the persistency is high enough. I don't know if high enough is a good phrase. It sounds as if you like lapsation. But, the lack of a better phrase, the lapsation's high enough that I think we actually anticipate no problem. I don't know if Helen could comment on this.

MS. HOFMANN: Even if it were an issue, I think, if you're talking about older issues which have already had the assumptions locked in, you can't unlock the assumptions unless you have a recoverability issue. So, if I understand your question correctly, I think you're stuck with your assumptions.

MR. JOHN M. LENSER: I have a question that I would direct initially toward Bob Beal. You said that in setting a margin for adverse deviation on the policy benefit reserves, you had chosen something that was on the order of 5–10% of your claim costs. You didn't mention a margin for adverse deviation in claim reserves. Could you comment on margins, if any, that go into claim reserves. With respect to margins for adverse deviation in the benefit reserves, what kind of thinking goes into setting something like 5–10%, and what sort of literature is available to guide you on that question?

MR. BEAL: I'll answer the second question about how much thinking goes into setting your pad for your claim cost. Back in the mid-1980s, there wasn't much literature on that. I think it was more of a gut feeling of what the auditors thought were general practices? Actually, I haven't seen much literature on that, other than maybe some of the stuff that's coming out of Canada these days, on the active reserve basis. Relatively little margin was put into the claim reserves. The idea is that the claim reserves are not locked in, so you can adjust those at any time. I think from a practical point of view that it wouldn't hurt to put some kind of margin in there, but you want to have more margin, obviously, in your statutory reserves.

MR. LENSER: But you're saying that because you'll look at the claim reserve basis again every year, and look at the interest rate every year, and you may change it every year, there isn't the same argument for putting a margin in there for deviation?

MR. BEAL: Yes. That's how I view it.

HEALTH GAAP TOPICS

MR. LENSER: I had one other question on maintenance expenses and inflation, and Helen may have addressed it somewhat, but I don't think you did, Bob. If, in your pricing, you're using a per-policy maintenance expense and you're inflating it, which you may or may not be in your GAAPing, then, would you also be likely to hold a reserve to allow for that inflation in the per-policy maintenance expense?

MR. SHAPLAND: Our company does not set up any inflationary maintenance expense reserve. We think expenses will go down, not up, because of computerization and those kinds of things, and the activity in our company to cut costs. We think these will offset any kind of inflation factor. So we do not set up those kinds of reserves.

MR. BEAL: I like that argument, but some people in my company don't. I think if I was setting up a system now, I would probably push that position. However, back then, I was taking a traditional view and looking at it for policy expenses. Your whole idea is not how much margin is in your premium. For instance, if you have margin in your premium to take care of the increasing claim costs as well, you're doing it to smooth out the effect of those on your bottom line.

FROM THE FLOOR: Helen, you mentioned that Medicare supplement is one of your major blocks. With all the recent legislation, is it taken into account in your financial if you have a low early loss ratio because you may have trouble getting either rate increases, or you may have to give a refund through the refund filing? And how does that affect the bottom line? Does that pull it right down?

MS. HOFMANN: We have made some adjustments to our products that have allowed us to be more aggressive. As a result of that, we think that our methodology for the GAAPing process is conservative. In other words, we think we do have the margins and the premium.

