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Selling Your Individual Disability Insurance (IDI) Block Through Indemnity Reinsurance

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Moderator: ROBERT W. BEAL
Panelists: G. WILLIAM BOYD
SCOTT R. MUNSE
Recorder: ROBERT W. BEAL

Summary: As the IDI market has been consolidating, a number of companies have sold or are looking to sell their IDI blocks. Other companies are interested in acquiring these blocks. Changes in assumption reinsurance regulations have made indemnity reinsurance more appealing. The audience will understand the significant considerations in selling or buying a block of IDI business, relative to reinsurance, valuation, tax, and regulatory issues.

Mr. Robert W. Beal: My other panel members are Bill Boyd from RGA Swiss and Scott Munse from Lone Star.

Many of you who are attending this session may work for companies that have individual DI lines of business. One time or another, your company and you may have been involved in individual DI insurance and have probably considered exiting this market and selling the in-force business. These discussions may be going on as we speak.

Your company's specific reasons for selling its IDI may be one or more of the following:

- Your company's strengths may be in completely different markets and the IDI line does not fit strategically.

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- Like many companies, your IDI line may suffer from perennially poor financial results.
- Your company may realize that it does not have the necessary risk management resources skilled in IDI to be successful and is unwilling to make the investment needed to acquire or develop those skills.
- Your market share of the IDI market is small and shrinking.
- And to make matters worse, the IDI market is consolidating, leaving a handful of players.

In preparation for this session, I listed 26 companies that have exited the IDI market since 1990. These 26 companies represented over 35% of the total new business premium from the 1988 Life Insurance Marketing and Research Association (LIMRA) survey. These numbers show the amount of market consolidation that has occurred. Although some of these companies continue to manage their IDI business as closed blocks, many companies have sold their IDI in-force business to other carriers. A few have tried to sell their business and failed.

There remains considerable interest in selling blocks of IDI business and a number of companies still interested in buying them. If your company is one of those companies, then it is critical that it understands the methodologies and issues involved in selling a block of IDI business in order to attain the best value for the business.

The first speaker is Bill Boyd, who will discuss high level issues from the seller's perspective. I will follow Bill, still keeping the seller's perspective but emphasizing the nuts and bolts of preparing your IDI block for sale. Scott Munse will wrap things up with the buyer's perspective in the purchase of a block of IDI business.

Mr. G. William Boyd: I'm going to speak about selling a block of IDI business, specifically the high level issues from a seller's perspective. In particular I'm going to talk about who the likely buyers of a block would be, the marketing of your block, deciding between assumption and indemnity reinsurance, selection criteria for the particular buyer for a block, and personnel and financial considerations.

You might want to know who might buy your block. They would probably come from any of three genres. One would be specialist DI acquirers. One example of such a company would be Lone Star which is Scott Munse's company.

Some reinsurers specialize, to a degree, in DI reinsurance and they might well have an interest in completing an indemnity reinsurance acquisition. Also the major DI carriers are, from time to time, either buying or selling DI blocks and might have an interest.

Before you start the process you probably want to develop some preliminary criteria for what you're looking for in a buyer of the block. Obviously you'll want to consider the ratings of potential acquires as well as their current position in the disability market. Are they competent to service what will be your ongoing policyholders under other lines of business such as life insurance or annuities?

Obviously you want to make sure that the potential buyer has sufficient size and capacity to acquire your block. You probably wouldn't want to go to a company that is going to triple the size of the company when they make the acquisition.

Finally, you want to consider the degree of strategic fit your block would have with the potential acquire. For example, your company may have begun offering DI insurance a decade or so ago as an accommodation to its field force. Since that time, the line hasn't really thrived the way you might have hoped. The experience hasn't been that great. Your company may not be making a whole lot of money on it, and so it decides to sell it. But that doesn't mean that you don't still want to provide an IDI product to your field force. To the extent that you do still want to accommodate your field force, you may find it desirable for the buyer to provide your field force with its product either on your paper or the buyer's paper. You should certainly consider the IDI products that the buyer offers. Is it comparable to your product? Does it speak to your market? Also, is it consistent with your field distribution methods?

You might consider using external expertise in carrying out this acquisition. As will become clear, it's a complex process. You might involve either an actuarial consultant or a reinsurer or an intermediary or you might even consider an investment banker.

These parties might provide services in the area of valuation of your block, in terms of identifying viable candidates to acquire your block, and also in addressing various technical issues.

Before actually starting to communicate with the potential buyers, you probably need to have preliminary work done. You need to put together some sort of limited preliminary package to provide to the buyers. If your block is large enough to justify it, you probably want to have an actuarial appraisal done and provide that to the potential buyers.

Certainly any materials that you send out should be preceded by a confidentiality agreement, and that should be treated seriously. You would want to go ahead and establish a deadline for expressions of nonbinding interest. Based on these

expressions of interest you would want to develop a short list of potential acquires that you would actually go through a due diligence process with.

Of course then you want to begin to assimilate the material to support the due diligence process. You need to develop a preference for indemnity reinsurance or assumption reinsurance. They're very distinctive, different animals. Indemnity reinsurance, just for your background, involves maintenance of the seller's relationship with the policyholder.

That may be a bit of a scary proposition. Therefore when you carry out an indemnity reinsurance agreement, you're almost certainly going to also want to have a legal indemnity. If the buyer then assumes administrative responsibility for your block, including claims adjudication, obviously there could be some legal issues arising out of that. As seller, you definitely want to be indemnified by the buyer in the event that you are named in a suit as a result of the buyer’s activities.

Probably the best thing about indemnity insurance though is that because you still have a legal relationship with your policyholders, you really don't have to communicate anything to them concerning the reinsurance agreement. That's a major advantage that will be clear later on.

Under assumption reinsurance, on the other hand, policies are actually novated over to the buyer. Ideally, the seller's obligation is entirely extinguished. However, you do have to notify that policyholder in that case. In fact, the policyholders must be given a full right to reject the assumption on an individual basis if they so choose.

There are numerous advantages of indemnity reinsurance. Probably far and away, the biggest one is that you can just do it. There's no policyholder communication required. In contrast, assumption reinsurance requires that you offer an option for each policyholder to reject the assumption for three years. Obviously they can respond to your offer sooner than that, and you can act accordingly. But you have to hold that option open for three years.

Assumption reinsurance was much more common prior to the current regulations that are out there. These regulations are in the form of the Assumption Reinsurance Model Act that was promulgated in 1994 and is now part of the insurance regulatory agency accreditation package. I'm not exactly sure how many states have it now, but a majority do.

Another major advantage of indemnity reinsurance is that by minimizing communication with your policyholders, you necessarily minimize the shock to

them of the sale. The one thing that you have to be careful of is that the buyer will probably want to take over administration and claims functions. To the extent that it does, you'll want to make sure that transaction is communicated and goes smoothly.

Indemnity reinsurance offers you a great deal more flexibility, particularly in financing. This is partly because you do have two entities involved, which gives you the opportunity to inject some low-risk, low-cost reinsurance capital into the buyer's offer.

Also you may have a choice of where the claim reserves and the risk-based capital might reside. Also from a tax perspective, under assumption reinsurance, the buyer will have to capitalize and amortize any tax loss that it incurs in making the acquisition, and that would probably then be reflected in the price that the buyer would offer you. On the other hand, under indemnity insurance, you can deduct that tax loss immediately. That's of course only significant assuming that the buyer paid such a price that it incurred a tax loss. That's another issue.

Also, you can probably entertain a somewhat wider field of acquires on an indemnity basis than on an assumption basis. Let's say that your company is an A+ rated insurer, and you want to sell your DI block. You probably just wouldn't consider doing an assumption reinsurance agreement and then sending out notices proposing to have your policies assumed by a C-rated carrier. You might even think twice about sending out notices for an A or A– rating just because you're asking the policyholder to make a change and trade down in terms of ratings. With indemnity reinsurance, you don't have to make those notifications. As long as you're comfortable with the financial condition and stability of the eventual acquire, that will probably work for you.

Then there are some advantages of assumption reinsurance that should not be overlooked. First and foremost is just the permanence and finality of assumption reinsurance. And how you weight that one depends on how far away from that disability block your company wants to get. Is it just an opportunistic sale to raise capital and see what the block will fetch? Or do you really want to punt it away to infinity and beyond?

Ideally, assumption reinsurance totally extinguishes the involvement of the seller. But this is true only to the extent that there are no affirmative rejections of that assumption. With indemnity reinsurance, on the other hand, you're definitely not going to extinguish that legal liability. You have to continue to report and explain to rating agencies your DI block, even though you no longer have the risk for it.

Finally, the buyer might value having a direct relationship with your policyholders and field force. Maybe you get a marginally better price due to this. But then you have to consider how comfortable you are with that buyer and whether it might abuse that right.

It's also possible to do a hybrid arrangement in which you would have an indemnity reinsurance agreement first. As policies consent to assumption, you would have them assumed. It's conceivable that you could get the advantages of both forms of reinsurance if the assumption goes smoothly.

However, just keep in mind that somehow, some way, there will always be some policyholders that will affirmatively reject that assumption. As such, you could get the disadvantages of both forms of reinsurance.

Next, you have to get on with selecting the buyer. Obviously you will want to consider the price offered by the various buyers. As is probably clear by now you're going to have a number of relatively complex agreements involved in this, and you need to consider the editions and the letters of intent relating to those various agreements.

Obviously you would want to consider the image and the financial conditions of the potential buyers.

Price is always an important consideration. You would want to consider whether the buyer is willing to offer its DI product to your field force. That might be a key issue for you. Once again do you have a strategic fit? How will the product be regarded by your field force? Is it a strong product that they will be pleased to sell?

You really must consider whether your field force will sell the buyer's DI this week, the buyer's term insurance next week, universal life the following week, and annuities the next week. The next week, they're not your agents anymore.

There's really no silver bullet to avoid this possibility. It's an issue that you need to be comfortable with, with respect to the particular buyer. Finally, you want to make sure that the sale is viewed favorably by the public and the policyholders. Maybe they don't even know under indemnity reinsurance. You want to be comfortable that your policy improved at an acceptable level perhaps. Last but not least you certainly need to consider the price offered.

You need to consider the impact of the transfer of administration on employees. Presumably the buyer will want to administer the block and you may well want to be relieved of administrative responsibilities. This could mean a loss of a significant

head count. You also need to consider the impact on retention of your other employees. Probably confidentiality in regard to the sale is an issue, at least prior to the transaction becoming a certainty.

Finally, there are ancillary financial implications. By selling the block you're essentially becoming a smaller company. The sale will probably have an adverse impact on your overhead allocations. It will no doubt have an impact on your surplus allocations.

Finally, you need to go back and take one more look at your provisions for adverse deviation in your GAAP reserves. You need to look at those from the buyer's eyes. If the buyer doesn't deem them adequate, you could be staring at a GAAP loss on the consummation of the sale.

Mr. Beal: I will be getting into the nuts and bolts of selling your block. I would like to cover the following topics:

- Some key points in building a financial model of your IDI business
- Using the financial model for testing the adequacy of the statutory reserves, and
- How to calculate actuarial appraisal values and possible purchase prices from the financial model

There have been a number of transactions where there are no financial models prepared by the sellers. This is unfortunate because one of the most important considerations for a buyer is the quality of information. A well-prepared financial model by the buyer is an excellent source of information.

There are four components to the financial model: (1) the current claim block, which takes into account claims incurred prior to the initial date of the model, (2) the policies in force on the initial date and claims incurred on these policies after the initial date, (3) the new business, which for closed blocks of business arises mainly from policies in, and (4) exercising future insurability options and contractual automatic indexing provisions.

I have used two methods for projecting the current claim block. The first is the Seriatim Method that projects the future claim payments and statutory claim reserves for each claim that is open and approved. Of course, to do this realistically, you will probably need a table or tables of claim termination rates, which reflect your business' own claim termination rates. This may require a separate actuarial study, if a study has not been completed recently. A word of caution may be appropriate here. Unless you can definitely demonstrate that 100% of the 1985 Commissioners Individual Disability Table A (CIDA) table appropriately

represents your block's claim termination rates, don't use it. The unadjusted claim termination rates of the 1985 CIDA table are generally recognized as inadequate.

Once you have the seriatim projections of the open and approved claims, you may then need to project the run out of your pending claims (i.e., those claims that are open but not approved), the reopened liability, and the litigated claims liability.

It is appropriate to extend the Seriatim Method to the pending claims. Claim reserves for pending claims are often determined as a specified percentage of the corresponding tabular claims. Consequently, you may want to multiply the projected claim payments and associated claim reserves for the pending claims by the same percentage.

Projecting the incurred but not reported reserve (IBNR) may be more difficult since these claims are not known. However, you may have developed historical percentages to represent the IBNR by years of incurral. For example, for your December 31, 1996 IBNR, *X*% is expected to be from claims incurred in 1996, *Y*% for claims incurred in 1995, and possibly for claims incurred in 1994.

The portion of the IBNR attributable to 1996 incurred claims could be projected in total by multiplying the projected claim payments and claim reserves for the December 31, 1996 open and approved claim reserves for claims incurred in 1996 by the ratio of 1 to 2 where 1 is X% of the IBNR and 2 is the December 31, 1996 open and approved claim reserves for claims incurred in 1996. Likewise, you could project the portion of the INBR representing 1995 and 1994 incurred claims.

If you maintain a separate reserve to approximate the liability associated with reopen claims in lieu of implicit margins in the reserve basis, then you could use a similar approach for projecting claim payments and claim reserves for the reopen claim liability.

Litigated claims may be projected on a seriatim basis if the individual claims are known. Or you may choose to project this liability in proportion to the rest of the claims in total.

Finally, do not forget to project future claim management expenses, regardless of whether you reserve specifically for this liability. I prefer to use a fixed percentage of the paid claims to represent the ongoing claim management costs.

I have used a second method, which I refer to as the *development method*, when neither a seriatim claim listing nor company experience claim termination rates

were available, and the block of business was relatively small in size. This involves several steps:

1. First, an analysis of the historical claim reserves was done to demonstrate that the current morbidity basis (or a modification of the current basis) was adequate given a specific valuation interest rate.
2. Then develop an historical run-out of paid benefits. That is a series of percentages that related one year of paid claims for a closed block of claims to the prior year's paid claims.
3. Next, I estimated the paid claims for the first year of the projection based on the level of paid claims in the prior year.
4. Finally, given the assumption that the claim reserve basis was adequate, I used this equation to project future claim reserves.

Although a seriatim approach for projection of your open claim reserves is probably preferable, this development method can generate reasonable projections if you can demonstrate the overall adequacy of the claim reserve basis.

I would like to touch upon the following issues associated with the projection of the active life in-force business:

- Methodology
- Morbidity Experience
- Expenses
- Required Surplus
- Interest Rates
- Deferred Acquisition Cost (DAC) Tax
- Reconciliation and Validation

With respect to methodologies, a multiple cell model is much more preferable and credible than an aggregate or windshield approach, if you have the time and resources to develop a multiple cell model. However, the aggregate or windshield models serve a purpose in giving management a relatively quick assessment of potential values. Generally, my remaining comments on modeling refer to a multiple cell model.

In choosing your morbidity experience assumptions, it is advisable to reflect your company's own experience wherever possible. In addition to age and sex, common experience differentials are elimination periods, benefit periods (particularly, with and without lifetime benefits), geographical (e.g., California and Florida), and occupational (whether by occupation class or by key occupations).

One of the more sensitive morbidity assumptions, as well as most difficult to measure accurately, is selection. Many companies feel that their morbidity

experience reflects some level of selection. However, there is no standard set of selection factors. If you inadvertently reflect an unrealistically steep slope in your selection factors, then you may be building an unexpected level of conservatism and thus understating the underlying value of the business. For example, if you try to adjust your early projected claim costs to be in line with more recent morbidity experience, which may have been less than favorable, then a steep set of morbidity selection factors is telling the buyer that if you think the recent experience was bad, then just wait until the selection wears off.

My final thought on morbidity experience deals with two other possible adjustments to future claim costs. First, it is getting to be more common to include some modest level of secular deterioration. At a minimum, secular deterioration morbidity adjustments give a slightly conservative slant to your projections, which may suggest to a potential buyer that your heart is in the right place. A more controversial adjustment to future morbidity experience is in recognizing possibly better experience in the future. Examples of this include assuming that the poor physician experience will ultimately correct itself as more physicians get used to the world of managed health care and stabilized incomes, and assuming that the buyer will have a more effective claim management organization. Any of these assumptions may be open to debate with a potential buyer.

I am a great believer in truing up your early projected claim costs to historical interest-adjusted claim costs over the last five or six years. The interest-adjusted claim cost for a specific calendar year is the present value of disability benefits paid on claims incurred in that year plus the present value of the current claim reserves for all claims incurred in that year and still open. The interest-adjusted claim costs are your best representation of the claim costs associated with the particular years of incurral. The interest-adjusted claim cost ratios are simply the interest-adjusted claim costs divided by earned premium. I find it disconcerting when analyzing an IDI financial model to find the interest-adjusted claim cost ratio in the initial year to be, say, 65%, when the historical ratios have been 75–85%, especially when there is no explanation for this discontinuity.

Obviously your active life model needs to project commissions, premium tax, and maintenance or operational expenses. There is usually a lively debate about whether to include overhead. I recommend that a seller not include allocated overhead into the projection from which an actuarial appraisal value will be calculated. A buyer may choose to allocate some of its own overhead to this business, but I think a more marginal approach to overhead expenses may result in a truer picture of appraised value.

On claim management expenses, I like to represent them as the sum of two components. The first represents the cost of processing new claims and may be represented as a percentage of the interest-adjusted claim costs. The second represents more ongoing claim management claim costs, which may be represented as a percentage of paid benefits. These ongoing claim management expense percentages should probably be consistent with the ones used in projection of the current open claims that were discussed earlier.

In order to project actuarial appraisal values, you will need to project required surplus. However, your own required surplus formula may not be appropriate. A buyer may choose to incorporate his own formula. If you want to illustrate projections with required surplus, you may want to use the NAIC Risk-Based Capital formula.

To calculate net investment income, you should consider basing interest rates, at least initially, on new money rates, adjusted to reflect investment expenses and asset defaults. Using your current portfolio interest rate may not be appropriate, since the current market value of the assets will be transferred to the buyer.

To project the annual DAC tax, keep in mind that you may want to amortize 7.7% of net considerations, instead of 7.7% of premiums, since the transaction is co-insurance. Net considerations are defined as premiums less paid benefits less reinsurance allowances. Some actuaries choose to amortize based on premiums with the provision that there will be an allowance paid annually between the seller and buyer not reflected in the projections to arrive at the same end result.

When you are almost done with your model, it makes so much sense to reconcile the certain starting values of your model (like statutory reserves, in-force premium and number of policies) to the actual values. This may require deriving overall adjustment factors to apply to premiums, for example, to get the initial premium in-force to agree with the actual value. Another way to add substantial credibility to your model is to run your model as though it were beginning a year or two earlier, so that the model will project financial results for the last year or two. You can then compare these projections to actual financial results and, thus, validate the model's reasonableness.

As I said earlier, if you are selling a closed block of IDI business (and they typically are closed), you should still recognize the new business arising from future insurability options and/or automatic indexing. In projecting these values, you should probably reflect the higher morbidity experience that is often associated with these contractual increases in coverage.

Once you have your financial model together, it is a worthwhile exercise to calculate a gross premium reserve based on the projected values. The gross premium reserve is equal to the present value of paid benefits plus expenses plus the claim reserves and active life reserve at the end of the last year of the projection less the present value of premiums. By comparing this gross premium reserve, you may identify and have a chance to address potential reserve adequacy issues before a buyer does.

The Actuarial Appraisal Value is equal to the present value of statutory profits after federal income taxes and after the contributions to required surplus. Remember, in this calculation, the beginning-of-the-year assets are set equal to the sum of the statutory reserves and required surplus. The discount rate used in the calculation of the actuarial appraisal values reflects a potential buyer's expected internal rate of return.

The theoretical purchase price is equal to the actuarial appraisal value plus the net taxes to the seller from the initial transaction. Typically, a buyer may give you a purchase price, and you may want to back into an implicit actuarial appraisal value. You can then compare this implicit value to the actuarial appraisal values from your model.

The taxes incurred at time of the initial transaction consist of three components:

1. First, the tax of the difference between the statutory and tax reserves is typically incurred by the buyer and a credit to the seller.
2. There will be a DAC tax incurred by the buyer on the cash transfer; that is, the statutory reserves less the purchase price. This will be also be a tax credit to the seller. However, remember to offset the financial impact with the present value of the amortization.
3. The seller will incur a tax on the purchase price, say 35% of the purchase price, assuming that the purchase price is positive, which is not always the case.

This wraps up the nuts and bolts that I wanted to cover. There were a lot of topics that time did not permit to be covered. However, it is time to turn things over to Scott Munse who will provide the buyer's perspective on the transaction.

Mr. Scott R. Munse: Believe it or not, I'm going to come from the buyer's perspective, and believe it or not there are buyers of this out there.

Lone Star has been in the disability business for over 40 years. We're probably not as well know as some of the larger companies but we have acquired more than 20

blocks over the past eight years. Through this, we've basically doubled the size of the company in terms of premiums and in terms of assets.

My particular role in this exercise has been prospector, appraiser, negotiator, document drafter, conversion facilitator. At a smaller company, you have to wear many hats. And this has been very rewarding in terms of many exciting experiences.

Why do buyers buy this business? They need to improve their return on equity. Free surplus doesn't earn a great deal by itself and you can earn theoretically higher rates depending on the price you pay and how you manage these blocks of business. You, therefore, leverage your resources to a greater degree.

It also provides for more efficient use of your management. It allows for broader supervision capabilities on your part, better use of your marginal time, and more opportunity for you to innovate. Your professional experts get to branch out. In fact, as they look into these new blocks of business and how other companies manage them, they get exposure to new ideas, which helps with your overall blocks of business.

Obviously, if you think of some of the expense issues, critical mass has improved. This is one of those situations where you want to build on your strengths. You want to have more of the things that you think you're good at. In this case, if you think you're good at managing your disability risk, and you have expertise in place, you want to build on that as a base and reduce your unit costs and expenses.

You may also get an improved spread on your core business that you want to get into. This may not appear obvious on the surface since you're getting more and more DI as you acquire these blocks. By their nature, each block is a different block and is distributed differently in terms of marketing and distribution, in terms of the policy forms and provisions of those forms, and in terms of the geographical distributions. All these really lend themselves to a better spread of risk. Of course, the other benefit is the growth, as Lone Star has experienced. Again, this allows you to focus on your company's strength.

The strategic considerations that have to be taken care of from the buyer's standpoint include:

1. Are there blocks available?
2. Do people want to continue to manage their own blocks?
3. Who are these sellers?
4. Where are they?

In general, selling companies are companies seeking solutions. As mentioned earlier, these blocks are closed. There's no new marketing going on, although there are times when they want to continue some kind of marketing relationship. They see that they have a stepchild of a block of business, and they aren't managing it successfully. Their expertise has been going elsewhere. It's hard to form a career path for people when they don't see the future in the business. Something needs to be done. The solution, oftentimes, is to divest yourself of the block.

Another item that has come up most recently is the systems changes that will come up in the year 2000. Many companies are addressing those issues and either converting to new systems or other solutions. This is a unique block of business, as you all know and to continue managing it on your system involves special consideration. As you identify your candidates and the particular types of business you want to acquire, you need to consider these things.

New business is typically not a consideration. As Bill mentioned, these are closed blocks. They are orphaned and treated as stepchildren, but marketing can be worked into it. We have included provisions in our agreements that state we will not enter into any licensing agreements with their agents.

We've talked about assumption reinsurance. There really wasn't much block transfer going on until the late 1980s that I'm aware of. Assumption reinsurance was the way to go. It was easy, it was fast, and you could do it just about overnight. You didn't have to get the approvals of all the parties. It seems to me it was a professor of insurance somewhere that had everybody interested. The regulators got wind of it, and the world started to change. Although some of us tried to avoid some of these changes, it was inevitable. We even went through a period where we tried to do assumption reinsurance but ended up with some policies on assumption reinsurance and the rest of them electing to stay with their original company with 100% co-insurance in effect.

Nowadays, I think it's rare, unless a state is involved, that you would do assumption reinsurance. It is very difficult to do and so indemnity reinsurance has become the preferred approach.

Let's consider the administration aspect. You'll notice I'm getting into issues that aren't pure actuarial. The considerations associated with blocks of business being acquired and divested aren't solely actuarial. There are business decisions and many other considerations, as well. So you have to branch out.

One of the things you need to determine on the administration side is claim processing. Typically, the existing open claims are transferred to the buyer,

although sometimes that's a topic of discussion. The buyer typically wants to take those over as soon as possible, and how to make the conversion quick becomes an issue. What basically happens is once an effective date is set and the risk is transferred, the ceding company is paying claims that belong to the buying company. As a buying company, I'd sure rather manage my own claims. There are also issues related to reinstatements, underwriting guidelines, matching premiums on the billing side, and supporting all the billing methods, including the most recent entry of electronic fund transfer. If you convert a block of business from a company that has some of these capabilities to a buyer that can't support them, there are awkward consequences.

What hasn't been mentioned so far is agent compensation. Make sure you satisfy the agents. They are also customers of a sort. You will get complaints if you don't take care of the agents.

There are also some correspondence issues from the policyholder and the agent standpoint that need to be supported. There are, of course, resource availability and risk-based capital concerns. Your internal allocation of surplus needs to be addressed. The buyer is very interested in timing, as is the seller. The seller wants to exit the business as soon as he can. The buyer wants to get it in as soon as he can. It seems to me that it is a good match-up. Confidentiality begins in earnest as soon as the data start transferring from the seller to the buyer.

The identification of the candidates can be done through several means. I've seen it done through mail solicitation, although, I'm not sure of the success of that. Oftentimes, we get word through brokers, from direct phone calls, or through our reinsurance clients.

Beyond identifying a candidate, the buyer needs to identify the type of business it wants to acquire. Will you consider a wide variety of DI? Does it include accident only? Accidental death type benefits? Are there side restrictions? Lone Star has done up to $15 million on a block of business in terms of premium. Does the acquiring company have its limitations? Are they so large that they don't want to address the smaller blocks of business?

Another critical piece of data that the buyer needs in this preparation process is the key policy forms. Are there specific provisions within the policy forms or riders that the buyer will have problems supporting? Also the buyer needs experience data. The data most acquiring companies like to start with are simply found in Schedule H. It's the easiest form to start, and most companies have that data for this type of business, or this particular block of business. That leads to many other questions

and other information, including the reserve methodology itself and whether there have been any changes in that reserve methodology.

We talked about the allocation of capital resources. There are other resources you have to allocate, as well. Analysis of the smaller blocks of individual disability business are almost strictly actuarial upfront. It may not take a whole lot of those resources but it does require of those resources that you allocate for this purpose. There are some blocks of business where the buyer needs to also commit resources of a claim expert to go on sight to check files out. From an underwriting perspective, there may be a lot of guaranteed insurability option type provisions out there, representing some form of new business still coming in.

As you work through the process there are also other resources that will come into play including your systems area and your area that sets up all your plan files and your internal files to get the block on your system.

Once all this information starts coming in there needs to be a way to allocate this information. There is a question and answer period that allows you to really get your hands around the information. The more you understand the data, the nature of the data, and how it was arrived at in the history, the more competitive the bid and the buyer can be.

So generally there is an on-site visit set up as soon as possible after the data are transferred to the potential buyer. It is a very short visit typically, but you've got to get some basic questions out of the way. Not only financial questions come up at these meetings. There are administrative issues, and you're trying to get a sense from the buyer of how difficult of a transition this is going to be. What's the conversion process going to consist of? Is there something that the buying company wants to pursue?

From here we should have the understanding to develop our appraisal model. From the seller's perspective he's going into some detail. I won't go into nearly the same detail, because it really is so dependent on the size of block. If it's a small block I'm going to do some very practical analysis. With the larger blocks, I'm going to get into some more esoteric situations.

I'm assuming for the moment that reporting these results will be done internally, although it can also be done by consultants externally. They need to take the form in such a way that they can be expressed in a letter of intent. The next step is, in a very short period of time, publishing a letter of intent. Assuming the buyer does want to pursue it and get a successful bid on this block, they have to put together their letter.

The letter of intent, if you aren't familiar with it, needs to include a few basic things, including the definition of the block, a description of the transaction itself, the effective date (make sure that's not a debate) and, of course, the ceding allowance and risk disposition. It might not be obvious, but sometimes all risks aren't assumed. For example, it may be very difficult to assume policy dividends or some kind of agent bonus structure. So these typically remain with the seller.

How is the conversion going to be approached? There needs to be a mutual agreement. Upon the execution of the letter of intent, there should be a mutual commitment between the companies to get this transaction completed.

Oftentimes, simultaneous with the closing is the due diligence, which is to verify, in detail, some of the representations that were made in terms of the numbers and the financial items and some of the litigated claims that were represented during the process.

With modeling again I'll stop short of details, but will include some of the considerations that a buyer would typically take into account. The level of detail depends on the size of the block. With a $2 million block of premium, you're not going to do very detailed work. It's going to be more aggregated. Typically, it's going to be thrown into one large bucket, and it's going to be approached very practically. With larger blocks, you're going to segment the business into more homogenous groups, and maybe segregate some of the unique benefits. One I like to isolate is the return of premium riders.

Then we get into the claim costs and loss ratios. As mentioned, the current tables are not necessarily representative of the experience on the block. They still depend on the provisions in the block, how long ago these policies were written, where they were written, and the type of insureds that they were written on.

But the buyer does use tables as guides when they try to reconcile results to the most recent loss ratios. Using this as a tool, the buyer may trend forward the loss ratio to get a pretty good feel relative to future benefits.

Reserve validation is done during due diligence. There are some basic tables and interest rates, where you want to align their methods with your own methods. You should expect the seller's methods may not be exactly what your methods are. So there is going to be a transition adjustment there.

How do they reserve for all their benefits? Are they doing it more conservatively than you would or more aggressively? There are some benefits that have no standard methods for reserving. There are some theoretically correct methods that

may not be practical, such as cost of living riders and social insurance supplement riders. Residual riders have probably been mispriced, as well as misreserved. Again, the return of premium benefit is another special story.

Also, simplistic reserve valuation items such as unearned premium reserves are not done the same way by all people. My favorite are the claims reserves and liabilities. There is a great deal of room for debate and you wouldn't believe the methods that are out there. They're just all over the map and they're not all bad either. They're just different. But they need to fit the particular occasion.

A key assumption is persistency. It's amazing to me, depending on the block, that favorable persistency can be either good or bad. You can imagine that with a very high loss ratio block of business, persistency is not always your friend, but it can vary depending on some of the other assumptions.

With the advent of indemnity reinsurance, you don't have much in terms of shock lapse, but you do have some repercussions, depending on how the transition is accomplished between the companies. If it's a rough one, then you may have some shock lapses.

These are typically cash transactions. At the closing, there is cash transferred, not in-place investment vehicles. What is the buying company going to invest this cash in? They need to consider what vehicles are available, what they plan on doing, and how that matches up with the liabilities being transferred.

Let me discuss the expenses and overhead. The buyer's perspective is such that his marginal expenses should be less than the seller's marginal expenses. You do need to put in some overhead. This is of course how these transactions work. The buying company can do it more cheaply since the unit costs are going in a downward direction. The selling company is going in the other direction.

The buyer has to take into consideration the expenses involved in the conversion of these policies. The conversion is not simple. It's very complicated. It's one reason why large companies don't convert and aren't interested in small blocks of business. They can write that much in a month. Why would they want to go through the hassle of converting it?

Tax considerations have already been discussed. Regarding the discount rate, I don't disagree with the range of 10–20%. In particular, my approach is to use 15% on a standard . With less comfort on the block and the information I've been getting from the seller, as well as more inconsistent experience data, I may choose to use a higher discount rate rather than more conservative assumptions in all of the

other places. I have to be very careful about compounding. Or I may go to a lower discount rate if I have a block of business that's very homogenous with a very steady past that I can understand very clearly. I may use a lower discount rate to be more competitive.

As a result of taking all these considerations into account, I want many of my assumptions to be sensitivity tested. Which considerations affect you the most? What I'm trying to do is put together a formal actuarial appraisal for my management. They can decide after looking at all these variables, and with some guidance from me, what we think we ought to bid for this block and what kind of range we have for negotiation on the block.

I want to touch on the conversion process. Again, this is one of those things where actuaries don't always do actuarial. Right after the close, there is further information requested of the seller. The selling company needs to be able to provide system files and record layouts so that we can begin the transition process. We used to ask for key policy forms, but now we need all the policy forms. Of course, getting all those old policy forms together may not be as easy as you might think. From this information, the buying company can now do a system file review. They will look through all these files and typically find something else either of an esoteric actuarial nature or a processing and servicing nature that just doesn't fit the norm.

With this information now the buying company can go on site and work on the conversion itself. As a result of that on-site visit, there is a need assessment that can be made regarding what kind of system changes need to be made, how many plan codes need to be established, and how many rate files exist. The internal workings make this all work.

File construction begins. Set up the plans and agents and matching rates. Matching rates is a serious consideration. If the buying company cannot calculate the match rates, there will be a multitude of complaints from your new policyholders. The only thing more serious than that is if you can't calculate commissions properly. Then you're going to get a lot of complaints from your agents. Those complaints are to be avoided.

Of course, the buying company then gets into all their model office testing. There are system modifications and the unit testing associated with these, as well as setting up communications. Bill alluded to how, with the advent of indemnity reinsurance, there wasn't as much communication needed as was needed with assumption reinsurance. In order to smooth out the process and avoid complaints (and complaints are really a waste of time), you should try to communicate as well as you can.

What Lone Star typically does is put a notification of the change in servicing to the policyholders. They don't need to know the reinsurance portion of it. There's only a change in servicing. It is sent in the selling company's envelope along with the letter from the selling company explaining just what has happened, why the servicing has changed, and why it is probably to their benefit.

Timing is of the essence in this conversion. Typically the conversion will take 90–120 days. I think everybody in the business labors to get it done quickly. All the incentives are for both parties to be as quick as possible.

There are some administrative issues that affect the value of underwriting of new business. There will typically be very little new business coming in. From an underwriting standpoint you have some reissues, reinstatements, and GIO exercises.

Regarding policy administration, you will need to have your people trained and reviewing all the policy forms. You should make sure that there is a consistency in the administration, and that you get the benefit of improved policy handling.

From an actuarial standpoint, the actuaries have to assume this business and from a valuation standpoint, they must be consistent with their methods, while melding in the effect of this block. It typically takes Lone Star about a year to fully digest the financial aspects of a block of business into our company.

Bill and Bob have covered the accounting considerations, DAC tax considerations, and ceding allowance deductibility. We haven't talked about the annual statement. From the selling and the buying perspective on indemnity reinsurance, the annual statement is involved, and there needs to be some intercompany reporting in that regard. For an example, Schedule T is direct premium; however, this is the ceding company's direct premium.

The ceding company still has direct premiums on which they still pay premium tax. This information has to be transferred. The assuming company has to construct A and H experience exhibits and transfer it back to the ceding company. There are other exhibits in the annual statement that are also affected.

Finally, the buyer is going to look back on these blocks they've consumed. You have to watch these blocks.

Mr. Andrew M. Perkins: Under the new rules for assumption reinsurance where deals have been done on that basis, do you have a sense of the range of percentage of customers who have rejected the transfer?

Mr. Munse: I remember one situation where it was in the teens, which is a surprisingly high number. It wasn't a DI block. But you have a sense of what that has been like. The last assumption reinsurance transaction we attempted was back in 1992. That one was about 50/50, but I'm sure it's much worse now. And like I said, I don't know of any company that's doing assumption reinsurance. They may be doing it if it's going from a small company to a larger company. I'm not aware of many of those. It's a very difficult transaction.

Mr. Mark Sullivan: First, a follow-up on the assumption reinsurance. Let's say you have 5% or 10% of the policyholders left. What does that mean as a practical matter? Obviously, the company change over still involves doing the administration and the claims. As a practical matter, what does it mean that policies stay with the initial company if the assumption reinsurance is declined?

Mr. Munse: What they retain is the benefit of the ceding company if the assuming company is ruled by the courts as financially unable to perform. That's what they get. If all the parties remain solvent, there's no practical difference. Bob, I have a question for you. Could you give some detail on how you would project future reopened claims?

Mr. Beal: Assuming that you can estimate what your total current liability is on reopened claims in a given year, I would try to allocate those reopened claims by year of incurral. For instance, suppose the starting date of your model is January 1, 1997, and I'm looking at the valuation end of 1996. Assume I can estimate reopened claim liability coming from 1996 incurals, 1995 and etc. For 1996 incurrals, I would simply multiply the claim projections associated with the open claims by the ratio of the reopen claim liability to the open claim reserve.

Mr. Munse: We come at this from two aspects of our due diligence. One is from the claim standpoint. Our claims person goes through claim files to look at the degree of past aggressiveness of closing the claim and the consistency of the claims handling practices. You can look at past years. You can look at the open claim listing from period to period, and you can see when they are reopened, so you can see if there's activity there.

The other aspect from the actuarial perspective is the impact of reopened claims on the adequacy of your claim reserves.

Mr. Robert B. Likens: Mr. Munse, you pointed out that you like to see a return, I think, around 10–15% when you purchase a block of DI business. Sometimes you would possibly go below the numbers that you mentioned for a block where there's a lot of uniformity in a cell block of business. What do you think sellers think a fair

rate is to give up to a buyer on a block of business these days? Do they generally come to a fairly quick agreement in the 10–15% range?

Mr. Munse: First, the discussion between the buyer and the seller does not include typically what assumption the buyer used as a discount rate in his calculations. If an appraisal is done for the seller, by someone such as Bob, that is typically used only as a tool by the buyer, to account for their own appraisal. So the discussion between the buyer and the seller does not include what kind of a return the seller may be expecting.

Generally, the seller decides they want to sell the business, and the price is either adequate or not. I really can't say what goes on in their decision-making process. That's up to the seller. We have focused on some of our lines of business more in the past several years and have sold a couple of blocks of business. We were willing to sell for what we could get.

Mr. Beal: I think that most companies realize that many buyers might want to get at least a 15% return on a block of DI business, primarily because the experience in this line of business has been so bad in the industry. There are substantial risks associated with assuming a block of DI business. They shouldn't go in with the expectation that there are going to be many companies' potential buyers that will bang their door down to get a 10% return or less on that block of business.