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Session 52IF
Which Form of Group LTD Reinsurance is Best for You?

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As your company's experience in group LTD grows, your reliance on your reinsurer to provide the necessary risk management and product expertise may be decreasing. However, group LTD reinsurance is able to provide a wide range of coverages to meet your changing needs. This session looks at how the group LTD reinsurance market has emerged and the advantages and disadvantages of the various forms of reinsurance that are available today.

Mr. Michael D. Lachance: Jeff Babino will be representing the automatic reinsurance market and Mike Johnson will be representing the facultative reinsurance market. This is intended to be an interactive forum, which hopefully should be a little bit more interactive than just a panel discussion.

What is turnkey LTD reinsurance? Basically, there are three dynamics or parameters upon which we define LTD reinsurance from a turnkey perspective. Number one is that it's a full-service arrangement. It is facultative in nature, in the sense that there's agreement on what the underwriting guidelines will be. In many cases, the reinsurer will do some of the underwriting services directly for the client. Typically, it's a quota share arrangement, meaning the average quota share for our clients today, for example, is about 70% reinsured. We do also have a few combination relationships where the client may take 50% of the risk up to, say, $5,000 a month. The reinsurer will take the excess over that amount.

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The typical reinsurance client, from a turnkey perspective, is a small- to medium-sized LTD producer, usually in a range of $0–30 million. They're typically regional carriers with a strong lead product such as a medical product. They're looking for additional premium growth, additional product diversification, and additional profitability. The typical relationship is a 50 quota share or more, which means the reinsurer will have the vast majority of the risk. Sometimes there'll be people in the organization who may have some disability expertise, probably in a prior life working for another LTD carrier or that kind of stuff, and they're interested in introducing the product line to their own company.

Mr. Michael S. Johnson: As Mike said, I represent the facultative side. Under the facultative agreement, we see both the reinsurer and the direct writer underwrite the risk, so on a case-by-case basis you have two sets of eyes that are looking at the risks separately. This tends to happen when the direct-writing company receives an application. There may be more risk than they want to retain. It may be, for instance, for a specific market or selective industries. The contracts, when they get a specific risk, tend to be negotiated prior to that. The purpose is, again, that they want to transfer this risk that is outside the bounds of their underwriting guidelines.

The second thing we see is it provides risk protection and risk management on cases and markets where the risk is large or volatile. Again, for obvious reasons, as we go through this, you will see that there's a lot of overlap between the automatic side and the turnkey side as to some of the issues that we have and how these arrangements come together. Facultative reinsurance brings specialized services, particularly when we talk about products like integrated disability. As the market moves, we're going to see that the facultative reinsurance gives the additional protection. The facultative reinsurance may bring resources with specific expertise, for instance, maybe the voluntary or the blue-collar market. They may be able to facilitate a clean buyout or transfer of liabilities to another carrier. The target market, though, for the facultative reinsurer tends to be large- or medium-sized insurance carriers. We tend to look at specific markets or selected industries and selected groups such as physicians' groups or things of that nature.

Mr. Babino: I'm going to talk about automatic disability reinsurance. The products that we offer are mostly excess, quota share, and stop loss. We also do some financial surplus relief on occasion. Automatic is best suited for mature, sophisticated disability companies who already have a disability operation up and running and just want some reinsurance to spread out results and some additional expertise and a second set of eyes to take a look at what's going on with their business. It's a follow-the-fortunes treaty. If the direct-writing company is profitable, we're profitable. If they lose money, we lose money, and we try to forge a partnership to kind of struggle through that. To set up the operating parameters

takes a lot of due diligence and work on our part to make sure we're comfortable with the pricing, underwriting, product marketing, and administration of disability claims. Anything that falls outside these operating parameters are done on a facultative basis. Mike just spent a fair amount of time talking about that, so I won't get into what happens from a facultative standpoint.

Mr. Lachance: We're going to take a look at the potential advantages and disadvantages of each of the different types of relationships for the direct company and from the reinsurance side as well, looking at it from a reinsurer's eyes. From a direct company's perspective, there are some potential significant advantages and disadvantages to a turnkey relationship. From a marketing perspective, it is a quick, easy, low-cost entry into the marketplace if you've never been an LTD carrier before. You have the opportunity to get access to disability expertise and resources without a lot of effort. Basically, you put your name to a treaty and get access to those kinds of facilities for yourself. You also get access to marketplace information, including things about what's going on from a straight underwriting perspective and from a product and underwriting perspective. The other thing you get is a security in a partnership because you're both sharing in the risk and have a common interest in making sure that the risk is going to be profitable; therefore, there's a commonality of interest for both parties.

The potential disadvantages are that if you don't have ownership in the product, you don't always get commitment from the product or commitment for the product within your own organization. The dependence on the reinsurer can sometimes create an inability to develop internal expertise. And then, similarly, in the future, as your LTD block grows, it makes it a little bit more difficult to go it alone. There are more adjustments that need to be made in the future to be able to take the product line on your own. It also makes it a potential competitive target, depending on if you're trying to go with all of the major LTD carriers and you don't have a name in the marketplace. That's a difficult situation to potentially be in because you're generally an ancillary product and the sales force may not be as sophisticated and as knowledgeable as the large direct writers in the marketplace. The other potential disadvantage is that you can have cost inefficiencies. If the reinsurer and the direct writer are both doing the same activities, then all you're doing is increasing costs. That's not going to make you competitive on the street, so you'll have that issue as well. Cost allocations are always a problem. Typically, companies that sell LTD on a turnkey basis will still allocate overhead costs to your line of business as if it were a direct organization; therefore, that causes some real expense problems potentially for the line of business when you're looking at its potential profitability.

From the reinsurer's perspective, there are some advantages and disadvantages as well. Again, the advantages are similar to the direct side in terms of having a good strong partnership. You get to share in the insurer's success but the disadvantage is that you share in the insurer's failure. If you invest a significant amount of time and effort in trying to get a company up and running with the LTD product, by doing the filing for them and working with them in getting their underwriting and sales training done and then, for whatever reason, they don't produce, you share in that failure, which is not always good. You do get, from an advantage perspective, the opportunity to feel like you're directly managing the business. Typically, the relationship is such that whatever information is being kept on the client's information systems is also being kept on the reinsurer's information systems, so there's a system of checks and balances going on there. And from the reinsurer's perspective, it's more like managing a direct line of business than it is like managing a reinsurance block of business, particularly from the standpoint of controlling risk and the predictability of your results.

Another potential disadvantage is that it's resource-intensive. You do need production staff and underwriters who are willing to commit to service standards for how they're going to turn around quotations for client companies and that sort of thing. You need lots of support staff, which means that there are heavy start-up and administrative costs in both people and systems.

Mr. Johnson: I'm not going to talk about the advantages to the reinsurer. Mike has already covered that. What I'd like to focus on are the advantages to the ceding company. I think probably the biggest advantage that you get from a direct-writer standpoint is that you increase your profitability with less of a surplus requirement. In essence, you're going to increase your return on your equity. That tends to happen because there are fronting or ceding fees involved. That decreases the surplus that's needed for your book of business. No one risk will dominate a particular book. For instance, you may have case and industry and market, but you can determine what's going to be passed on to the facultative reinsurer. The facultative arrangement also allows the direct writer to obtain specific market knowledge that they wouldn't normally be accustomed to, just because of the risks that pass through our shop. We're more aware of what the competition's doing and what the trends are in the market.

Some direct writers can use a facultative reinsurer, for instance, for a research and development department. In essence, that allows them to look at new and different risks that they perhaps might not have been able to look at before because of the investment risk to that company. They don't have to sell it, they don't have to do product development, and they don't have to get the systems in place. When we talk about integration, you don't have to get your network set up. This makes it less

costly for them to look at new markets. It also allows them to maximize growth. They can be competitive in any size market or for any type of risk because they have a reinsurer. Again, we're talking about looking at it with two sets of eyes, so the reinsurer and the direct writer are able, perhaps, to work together to know what the competition is doing. It allows a direct writer to provide services that they might not currently have available. For instance, we talked about the networks that we have. Then it provides integrated capabilities. Also, it allows them to expand the markets that they can be in. Because we talk about the sales force, they're not limited because they can pass off this risk to the facultative reinsurer. It also allows flexibility. One of the things that we do is claims buyouts, where we pass on liabilities. We're going to talk some more about that later on. But you also get the expertise, and then probably more importantly, the capacity of the reinsurer, for instance, to do some of the risk and the people so that that frees up some of the direct writer's capacities to do these other things. You then get the advice and the expertise of the reinsurer for all the risks that you're looking at.

If we move on to the issues, one of the major issues that people may think of with regard to facultative underwriting is the additional time that it might take because, again, you do have two sets of eyes and you are going through two sets of underwriting. I think this is pretty much less of an issue now than it might have been in the past because of the way technology is today. The direct transfer of information is almost instantaneous. A lot of facultative agreements are such that as soon as the direct writer gets information, they know that it falls in the guidelines, and they send it on. Reinsurers, just like anybody else, require a volume of business. You don't want any one set of risks, i.e., having all your eggs in one basket. You have to spread your liabilities. Because of that, you don't want a concentration in any selective industry or market. The quality of the disability case management varies greatly. All companies say that they do case management on their claims. I was talking to some people this morning at breakfast about their case management, and they have a nurse to do it. There's a broad spectrum of case management out there. Because of that, as reinsurers, we have to do a lot of due diligence to make sure, for instance, that contracts allow it and that there's not some hidden cost involved in some of these contracts. Then you have to make sure that there are cultural and philosophical issues regarding claims management. For some companies, their desire is to simply pay the claim. When you think about it, a lot of people measure our claims departments by asking did the checks get out on time, did we pay the right amount, and is the amount correct? We don't talk about any return-to-work issues or quality-of-life issues.

Sometimes direct writers have trouble admitting weaknesses because all of us tend to want to say, "We can do everything." We have claims people, we have underwriters, and we can do all these things. Direct writers have a fear of

outsourcing some of this work. I think an issue that we all need to understand is that a reinsurer truly wants to be an asset to a company. Any situation that we get into is going to be win-win. In essence we, as reinsurers, don't want to have all the game if the direct writer's losing, and vice versa. Finally, if integration or specialized services are provided, the reinsurer needs to look for a larger commitment. For obvious reasons you have to get systems in place, and you have to get networks in place.

Mr. Babino: I'm going to look at the advantages and disadvantages for both reinsurer and ceding company from an automatic excess and quota-share perspective. Looking at it from an excess perspective, the cost is relatively low. If you've looked at the marketplace recently, you've noticed that the price for automatic excess reinsurance is relatively cheap. It stabilizes loss experience from a size standpoint. It results in a good spread of the risk. The attachment point limits the exposure on the entire disability portfolio at $5,000–7,000. A typical attachment point is somewhere between $5,000 and $10,000. It's relatively easy to administer because most business is currently sold on a percent-of-written-premium basis. And it provides access, as Mike L. and Mike J. have both mentioned, to disability experience and expertise.

Another value that's brought by the reinsurer to the ceding company is that when we go through that due diligence that I spoke of, we really take a look at the entire disability operation and try to become comfortable with what they're doing from a pricing standpoint, underwriting standpoint, sales standpoint, product standpoint, and so forth. The mere quoting of the business really results in a consulting project that adds value to the company and to the operation. It's a check to see whether or not that company is doing what we feel is up to industry standards and practices. I know there are other reinsurers in the room, and one of the biggest values that we can bring to a direct writer is being a scapegoat, where your underwriters and actuaries can say, "Well, the reinsurer said we can't do it, so we're just not going to do it." I think that's a big value to people at times on a day-to-day basis. I get that all the time when I go and meet with salespeople and do some sales training. They'll say, "Well, you said we couldn't write this case and that case, and something else." I never heard of those cases, but the direct writer uses me as his scapegoat. At times, I'm not particularly popular when it comes to the salespeople. But I think that's one of those hidden values that you don't think about much.

Normally, from a quota-share standpoint, we have the automatic excess. A quota share comes into play when a company wants to introduce a new product or get involved in a new segment. It's a really easy way for a direct writer to get involved with that and limit their risk, with a 50-50 quota share, or higher. It really doesn't matter what the size is. Our requirement is that the direct-writing company retains

at least 20% of the risk. They can do whatever they want beyond that. Quota share stabilizes loss experience from both an incident standpoint and a size standpoint, as reinsurance from the first dollar of coverage. There's a true partnership with a quota-share arrangement. Quota share is much more of a partnership than excess.

What are the advantages for the reinsurer from an excess standpoint? We have to maintain a relatively small staff of consultants. We're not a production shop—we're not underwriting each case, we're not pricing each case, and we're not getting involved with the salespeople on a case-by-case basis. We do get involved on facultative quotes. There are things that stretch the operating parameters that we work with. It gives us an opportunity to work with top-flight disability carriers and experienced disability professionals. That's a real value to us because dealing with the top 25 or 30 disability carriers in the country really exposes us to the best practices in all aspects of reinsurance in all aspects of group LTD operation.

On a quota share the advantage to the reinsurer is, again, the direct writer was involved from dollar one, so there's more of a partnership and share of the risk. And there's a risk management incentive for the insurer to be involved and to manage that claim. If you take a look at an automatic deal, of a $20,000 claim with an excess of $5,000, the insurer gets $5,000 of that liability, but the reinsurer gets $15. On a 60-40, the insurer will get $12,000, and the reinsurer will get $8,000. So in that scenario, a quota-share arrangement would limit our liability from a reinsurance standpoint.

What are the issues for the ceding company for automatic disability reinsurance? It only really covers business that falls within the operating parameters, and it may explicitly exclude certain classes of business or certain segments of the economy. From a quota-share standpoint the ceding company cedes a larger portion of presumably profitable business, and there are opportunity costs associated with that. Those are the issues with both excess and quota-share reinsurance.

What are the issues for the reinsurer, automatic excess? It's a very price-competitive market, as I mentioned before. There's a lot of price competition amongst reinsurers to write the business. Pricing is more complicated than quota-share. We really have to underwrite and take a look at what the underlying pricing is for the direct-writing company. We have issues with quality, completeness, and consistency of data provided to quote the business, and that's a real struggle for us at times. We have to come up with a price with limited information and take a best guess on what the experience and what the reinsurance cost really should be. From a quota-share standpoint the major challenge is, how do you approach a renewal increase on an automatic quota-share basis? It's the direct writer's pricing methodology; it's their business. If we're both losing money, the only way that we

can really affect the amount of money that we get is to play with the ceding allowance, and that's often a touchy subject when it comes to renewal. So that's another issue that we have with a quota-share-type arrangement.

Mr. Robert W. Beal: Could you talk a little bit more about the pricing of the automatic excess retention? In particular, what do you use as a basis of your distribution of risk? I assume you don't price things on a case-by-case basis. Do you come up with some percentage of premium to apply to the whole book of business? You referred to a shortage of data, but it seems to price the automatic excess reinsurance fairly. You would have to have a pretty good distribution of risk data in front of you.

Mr. Babino: Right. I don't get involved directly with the pricing, but my understanding is that the actuaries, Nick Smith and Bob Lee, who work for us, would take a look at the direct writer's pricing and what the underlying price is for their business, get census information, as much as they can of experience information, and try to project what the reinsurance costs are going to be above the attachment point before the quota-share reinsurance arrangement going forward. The big challenge is that it's based on the current mix of business. If there's a change in the mix of business, then we have to try to predict that through some sort of census profiling mechanism that is beyond me but apparently works pretty well. We have to also price for salary information going forward. So it's as much of an art as it is a science.

Mr. Michael Francescone: I have a question on claims management. With the current litigious society we live in what kind of protection do the reinsurers provide, with regard to litigation, to the carriers?

Mr. Babino: I can start. We have a provision in our treaty that says we will participate in ERISA appeals and claims situations, but we will not be exposed to extra contractual damages or that sort of thing. So, from an automatic standpoint, we kind of look over the shoulder of our direct-writing client. We follow their fortunes, but if they receive an ERISA appeal, then we will go into a claims process where we investigate whether or not we want to participate in that appeal process. If not, we will commute the claim based on a prescribed reserve amount.

Mr. Lachance: From a turnkey perspective, we typically work directly with our clients and advise them, in some capacity, on what they should be doing with an individual claim. Our treaties are basically structured so that if the client agrees or goes along with what we've recommended for an action, then we're on the risk with them through the entire thing. If it goes to a litigation, there's a litigation risk that we follow that fortune. The thought process behind that is that we were the

ones who essentially recommended the action; therefore, if it leads to any sort of litigation, then we should be on the risk as well. If our client does, in fact, do something different from what we've recommended, then we'd have to deal with those on a case-by-case basis.

Mr. Johnson: From a facultative standpoint, it's not much different from the turnkey.

Mr. Lachance: We'll move into a little discussion about how pricing is actually done. From a turnkey perspective, the pricing is really essentially no different from what you'd be doing if you were pricing on a direct basis. The concept is that you'd be using the same type of direct pricing variables. Typically, the reinsurer does the pricing and provides the client with some sort of a rating methodology that they can use. It's fairly typical that you start with your claim costs. Those can vary by age, sex, income, plan design, Standard Industrial Classification, region, any other type of factor that a normal direct writer would have in his or her pricing. To that you add the expenses for both the insurer and the reinsurer, and explicit profit margin. The key is to test the overall result to see how that compares to what a typical direct writer might be charging in the marketplace to make sure that you're competitive.

On a graphical basis, if you start with the claim costs and profit charges and add the two together, you come up with your basic claim cost, or basic risk cost, and share that 50-50 quota-share arrangement between the reinsurer and the client company. In addition to that, you can add the reinsurer's expenses and the street loads for the client expenses. Typically, there's negotiation between what the reinsurance expenses look like compared to the direct writer's expenses because you really want to try hard not to duplicate expenses; otherwise, the product won't be competitive on the street.

Mr. Johnson: On the facultative side, the pricing is similar, as Mike said, to a direct writer. You have to look at the age, the sex, and the area. One of the things you look at is some of the offsets that are involved. You like to look at prior experience. One of the things that's different, though, is the expenses that are involved. When we produce a rate, we are giving a reinsurance rate—in essence, what we, as a reinsurer, are going to charge to the direct writer. They, in essence, are responsible then to come up with a street rate, which means that they have to add their profit, their expense pieces to this reinsurance rate, so that they can come out with something on the market. But that doesn't mean that we just come up with our rate and drop it in their laps. Because we know what's available in the market and what competitive rates are out there, we try to guide them and give them some direction

as to what would be a good street price for them. Obviously, it's to our advantage and to their advantage that both of us sell this piece of business.

The main thing about facultative is since you have two sets of eyes, obviously you have two sets of underwriters. That doesn't add a prohibitive amount to the insurance. The price is sensitive to the type and the volatility of the risk, as all disability is. But price is very sensitive to the case management capabilities. We've touched on this a little bit in the past about the levels of case management that different carriers have. Currently, for some of the business that we're looking at, we're seeing that we can increase our termination rates by upwards of 20% by doing some different things with regards to how we do some of our case management and some of the providers that we have. That translates to almost a 10% decrease in cost. So, this really plays a big part as to what the ultimate rate is. Especially, as we integrate the products more and start looking at setting up networks and things of that nature, prices are going to become more competitive across the board. Accordingly, the rules in providing services need to be clear between both parties: Who's going to do what, who's going to manage the claims, and who's ultimately going to pay the claims. Finally, rate guarantees are pretty common as far as two to three years.

Mr. Bambino: From an automatic excess standpoint, the way we normally price the business is as a percentage of portfolio premium or a percentage of segment premium where we have different rates for doctors, lawyers, investment bankers, and others. Due diligence, is very, very important to the pricing of the automatic excess reinsurance. It can be a daunting task to figure out exactly what you're looking at with the information that's provided. One of the things that we looked at and some of the challenges that we had, from a retrospective experience rating standpoint, was exposure analysis to analyze and quantify reopened claims. Often that data is sketchy at best. What are we going to do with claims of legal status, and how are we going to evaluate them? For Social Security offsets, if there's cost of living adjustment, what impact is that going to have on the automatic price going forward? For survivor benefits, is the data valid, can we trust it, and can we believe it? We have no choice but to believe it at times. Whether or not we can trust it really comes into the art of pricing the business.

From a prospective standpoint, we have exposure issues. How has the block changed, how will the block change in the future, and how do we price for that? We really have to look at salary inflation and where that's going and how that will impact our business if we're doing it on a portfolio-rate basis. What are the impacts of large cases? How are they going to be renewed? How is that going to impact our exposure and the rate that we're going to have to charge? What if they put a large case on, and it has a major impact on a mix of business? Can we price for

that. Maybe, maybe not. We have to measure the impact of rate increases and renewal programs on the direct-side basis, and factor that into our pricing of the automatic reinsurance. Then we have to measure the change in the mix of business by the average monthly indemnity. If the average monthly indemnity were increased substantially, and we haven't priced for that, then we have to deal with that renewal.

I've talked about salary inflation a couple times. One scenario would be if you had an automatic excess treaty with excess at $7,000, and the insurance premium is based on a percent of covered payroll and the reinsurance premium is a percent of premium. What happens if an employee's $10,000 salary increases by 10%? We'll assume a 100% benefit percentage for this example. In that case, the insurer collects 10% more premium and incurs $0 more risk. The reinsurer collects 10% more premium and incurs 33% more risk. So you can see that salary inflation really is an issue that we have to be careful with as we price the business.

From a quota-share standpoint, essentially it's a follow-the-fortunes approach. And as I've mentioned before, the biggest challenge with quota-share pricing is, what do you do at renewal if there are rate increases too? As I mentioned, the only thing you can do at that point is try to convince the direct-writing carrier to increase their base rates or to have an adjustment to the ceding allowance. That's it for pricing.

Mr. Lachance: Next we're going to get into some of the basic treaty provisions for each of the different types of reinsurance and how they're handled. From a turnkey perspective, the basic treaty provisions that have an impact on the relationship are a description of what the business is that's covered. Usually our arrangements are on an exclusive basis to cover all LTD business that the client company has, but occasionally we may be reinsuring just a subset of that business, such as a small-group product or a blue-collar product or perhaps a voluntary product that is a new entry into the market for them. It's very important that we be very specific in terms of what the business is that is covered. The coinsurance percentage, whether it be 50%, 60%, or whatever, is usually specified in the treaty. Our treaties are typically, from a term perspective, continuous, in the sense that they automatically renew every year. There is not a renewal process that we have to undertake every year in order to keep them in force. The typical termination provision is that the client company needs to give a 90- to 120-day notice, and they can stop the reinsurance going forward on any new business at that point in time. However, we do have a few relationships where, if we've had a significant investment up front, perhaps there's a minimum term to the treaty that says that the relationship needs to be in place for three or five years in order to give us an opportunity to recover some of our investment costs in the client.

From a recapture perspective, one of one of the most common provisions out there today is that the client company has the opportunity to recapture 10% of their business each year after termination. The other most common provision is something where they will have to wait two or three years to recapture 100% of their business. In other words, it just stays with the reinsurer for two years, and then they recapture 100% all at one time. The risk-transfer process is basically a description of the requirements that are necessary for the client company to meet in order to have the reinsurer be bound to a particular case. The premium remittance process outlines how premiums are to be remitted and what information needs to be transmitted, as well as the premiums. I mentioned earlier that we typically track on our systems the same information on a case-by-case basis as the client company does in order to be able to track what kinds of premiums are coming into us. We perform an additional audit function for the client company being able to track that information on our systems as well. Typically, the premium is remitted to us the 15th of every month, along with a seriatim listing of cases, of what the in-force premium is and what was actually collected by the insurer in the last month.

Also, there's a description of the claims and reimbursement process that gets back to the question that Mike asked before. When a claim comes into the client company, they will send everything that's in their file up to us. We will make a decision on the claim based on what we think we would pay from a reinsurance perspective. They also in some cases will look at the risk from their perspective and say what they would like to do. Then we have a meeting of the minds, in most cases, of how we're going to handle a case, and from there we jointly go forward in terms of any litigation liability or any additional liability that might be involved in the claims process. Most of our clients rely on our wisdom and judgement in terms of paying the claims. We do have a few clients who do have some expertise. Typically, what we will do is allow them to do some of the claims management, up to say $1,000–2,000 a month, or perhaps some types of disabilities that are easier to handle than others. We'll give them some automatic authority to be able to handle claims, and then we'll come in and try to focus our energies on the ones that really require some case management. The last real key provision is, what do you do in the event that there's a dispute? How do we handle that? Typically, there's an arbitration provision in the contracts that spell out which way that's going to go.

Mr. Johnson: The facultative is a lot like the turnkey, so I'm not going to reiterate a lot that Mike has said. But in facultative, you tend to have two- or three-year rate guarantees; that is, most of your newly written business. Because of that, the reinsurer prefers a longer term commitment from the direct writer. For obvious reasons, you want to go through one or two reinsurance cycles or underwriting cycles just in case, in the first year or two, that the experience is bad, so that you can make up for that adverse experience in the third or fourth year. The reinsurer

prefers a partnership, and those partnerships may include anything from profit sharing to fees for performance. You want longer term contracts. Again, you want a variety of risk. And most importantly, you want the win-win incentives. We want our goals and objectives to be going in the same direction so that we both have the same focus in mind—hopefully that's quality-of-life and return-to-work issues for the policyholders.

Mike already touched on the recapture provision. Typically, for the facultative, the ceding company is going to recapture the entire risk, and that could be an immediate recapture or two years down the road. And then, there's always the issue about what you do with the open claims. When the contract terminates—obviously, you have some old claims that are existing claims that somebody's going to be managing, and then as the direct writer perhaps gets into another insurance agreement or keeps more of this risk for themselves—the best way to handle that tends to be the buyout or the transfer of the liability.

Mr. Babino: The things that are receiving a lot of attention in the automatic market are the recapture provisions. I think more and more reinsurers are allowing immediate recapture in the event of a termination. The philosophy is, if you don't want to do business with us, we probably don't want to do business with you. We might as well have a clean break and move forward. The other issue, as always, is a rate guarantee. We're seeing more and more two-year rate guarantees. I haven't seen a three-year rate guarantee yet, but you never know.

Mr. Lachance: We thought we would get into looking at the services that are offered by various types of reinsurance programs. Starting with the turnkey, Jeff alluded to the perspective of having to do due diligence with the clients before getting into an excess arrangement. We also do due diligence, but we start with a different perspective. The excess automatic reinsurance expects that the types of companies they're dealing are experts in the field of disability insurance. The question is to try to find whether or not there are any weaknesses, whereas in our case we're coming at it from the perspective of saying, "They probably don't have a lot of knowledge about LTD, but maybe there are some pleasant surprises there." In a lot of cases, there are pleasant surprises with some of the client companies in terms of having some prior knowledge that they can bring to the table. So I think that's just a different perspective in terms of how it's approached, but you still have to go through the same due diligence process.

Some of the services that we offer are product contract, compliance, and filing support. In many cases, our client companies will actually ask us to do the filing for them, and we've been able to do that. Usually they don't have any expertise in doing the filing, and they really don't have the time to do the filing because they

typically have more product with their other product lines. The turnkey reinsurer will always have a set of rates that are available for the client company to use. We're starting to see that there's a little bit of customization going on from a rating perspective in order to create some differentiation among our clients. We would not want all our clients to have the exact same rating base and the same exact markets.

One of the things that we do with our client companies when we first start off the due diligence process is to search for the commitment of the company to LTD, relative to the senior management. If it seems like they're very, very committed, then what we do is we put together a whole sequence of activities that need to take place in order for them to be successful with the product line. So there's a strategy development. We help them to develop marketing materials, and we do a significant amount of training, particularly with their field force, underwriters, and claims people. From an underwriting perspective, we provide them with underwriting guidelines, and, in a lot of cases, we will negotiate with the client companies customization of their underwriting guidelines. I mentioned differentiation before. One of the things that we're trying to do with our client companies is to not have them go in the direction that everybody else is going, but to figure out what they're good at and what markets they understand. To see if there's some knowledge there that we can use to help them produce an LTD business within their own market segments that they're successful in within their own niches. From an underwriting perspective, one of the key things is actual production support. We have currently nine underwriters on our staff who actively produce quotations for our client companies. In a couple of cases, our client companies don't even have their underwriters involved at all. The quotations go directly from the sales force, either faxed or e-mailed to our offices. We do the quote and it goes right back to the sales office, and their underwriters never even touch it. That is because of an efficiency question. We talked about trying not to replicate or duplicate expenses, and from the perspective of those particular client companies, it's more effective to not get their underwriters involved at all and to use us as their underwriting shop.

From a claims perspective, we basically provide the advice and training to the client companies. As they get more and more sophisticated, we'll potentially give them more automatic authority to be able to handle different types of claims. One of the key functions that we is to test how their development is proceeding, is to do some audits. We also provide claim forms and other kinds of things that you need to administer the book of business. Certainly, from an actuarial perspective, we're like a miniconsultant. We do provide the rating methodology. We will provide the actuarial memorandums that go along with the rating methodology. After that, we're basically available to discuss any financial issues. We'll train our client

companies to handle reserves and to deal with issues from a reserving perspective. One of the things that we also get involved in is helping them to understand how to manage the book of business, which means you have to develop some management information systems (MISs). So we'll actually sit down with our client companies and help them to develop MISs that will be effective in terms of being able to manage the book of business.

Mr. Johnson: From a facultative standpoint, underwriting probably is the biggest value that we can add, simply because we have specialized knowledge in a lot of areas— larger risk, voluntary coverages, blue-collar markets, perhaps even niche or specialty markets, for instance, physicians' groups. Then we talk about claim and case management. As we move into integration, we're going to see more management even of perhaps short-term disability (STD) claims. That's where you have the telephonic medical case management where it goes directly to a nurse. Then you have physician specialists and the setting up of provider networks. For instance, you have specialized units that do case management, catastrophic claims management, and on-site rehabilitation programs. Then we have the statutory expertise. We have contracted networks that are already in place, which is more common today on the medical and the workers' compensation (WC) side than on the disability insurance (DI) side.

Facultative reinurers have the systems and the information available: case management, claims payment, issue policies, setting up networks. An important issue is benchmark data. I was in the STD forum yesterday, and they were discussing what someone without benchmark does to write STD. That's the value that a reinsurer can add because they have the experience. The answer was, we tend to rely on our own experience. If you don't have experience, you have to get it somewhere. Then we can help you set up guidelines, reporting systems, product development, strategic planning, and, obviously, actuarial work.

Mr. Babino: On the automatic side it used to be that automatic reinsurance was strictly a financial deal, but it's moving towards more of a value-added with additional services. One of the things that's really emerging in the marketplace is service guarantees. When we sell a treaty or negotiate a deal, we'll guarantee a minimum number of consulting days. For our clients, we offer a 30-day service guarantee. They can use us in any way that they want for 30 days throughout the year, whether it be in their office or in our offices in Portland, Maine. We'll look at pricing, reserves, and actual-to-expected analysis from an actuarial perspective. We'll do claims audits, claims training, and consulting. We'll do underwriting audits and training. And then, from a marketing perspective, we'll do product development, distribution strategies, and research and development. At times, we've been involved with some strategic planning at the senior management level.

The major change in the automatic market is really the service guarantees and the minimum level of service that goes along with the reinsurance treaty.

Mr. Lachance: I guess I would just say that when you start looking across the various forms of reinsurance, it looks like the services that are offered are very, very similar. But I do think there are some distinctions, particularly between the turnkey and automatic excess reinsurance. I think some of the lines have blurred over the last few years in terms of what different reinsurers are doing as they're trying to compete in the marketplace to get business. I think the biggest distinction is how much the reinsurer is actually doing versus advising. That's the way I look at it.

Let's take a quick look at some of the market dynamics. Certainly, from any of these types of reinsurance arrangements right now, there's certainly risk capacity that's generally available in the marketplace. That's not an issue. Thankfully, from our perspective at least, the number of LTD reinsurance competitors are involved in the automatic excess, automatic quota share reinsurance. We are involved with the turnkey reinsurance. Because of this distinction already in the marketplace. we don't run up against each other as much as you might think,. Certainly, from a turnkey perspective, our focus is on making the client successful in the long run. It seems like there has been plenty of turnkey business to go around in the last few years. That is because not just existing relationships, but new companies all the time are coming into the marketplace and adding an LTD product to their portfolio. It used to be that it was just employee benefits providers. Now we're starting to see interest from HMOs and other types of managed-care companies that are trying to leverage some of their expertise into other product lines. And so, they're looking for a reinsurer who can meet their short-term as well as their long-term needs. One of the areas of difficulty is to manage when you don't always have direct control over all of the activities that are going on out there. I think that takes a special type of person to be able to deal in that kind of environment.

If you look at some of the results of the 1997 data that we saw, very few of the larger companies who participated in the survey are happy about what's going on with the closing ratios. Even though there is some growth going on, there is a significant amount of churning going on in the traditional markets. Sixty-three percent of the respondents in the survey did not meet their sales goals in 1997. That's a fairly large amount, and I'm not sure if that means that their sales goals were outrageous or because the market dynamics are such that even with reasonably aggressive sales goals, they're still not meeting them. A vast majority, 68% of those companies, were also dissatisfied with their closing ratios. Almost half of those companies basically said that they thought closing ratios had worsened in 1997 over where they were in the past. So there's a lot of competition from a direct-side perspective. Profits are still below expectations, even though the

number is 3.1% for 1997. Very few companies are actually meeting their profit expectations at this point in time on the direct side. Therefore, the emphasis is on claims management, at least from what I've been able to decipher.

From our turnkey perspective, we've been reasonably isolated from some of that activity. Our clients have been meeting their sales goals, and we've been successful at being able to maintain our closing ratio targets. We've also been able to meet or exceed our profit objectives. Why is that? I alluded to that a little bit earlier. Basically our clients are small- to medium-sized companies, as I said earlier, with specialized market niches. What we're trying to do with our clients is to have them look at where they have strengths, where their market is solid, where they have relationships with brokers, and where they have relationships with other types of entities and to help them bring an LTD product that will fit within those avenues, as opposed to trying to compete directly with the large direct writers.

Mr. Johnson: From a facultative standpoint we're seeing continued movement from the indemnity market to managed care. That puts a premium on the claims management services of the direct writer. I think we're going to see a continued movement to integration. Again, you already have integration of WC with the medical. Now you're going to get medical and DI. Pretty soon you're going to have integration of all three of them. I expect that we're going to see some consolidation of insurance companies. I touched on this earlier—that we have insurers that try to do everything, and as Mike touched on, sometimes that's not their strength. Hence, I think we're going to see a lot more outsourcing because people want to specialize on that which they do well. Probably one of the most important things that we're going to see is a change from income replacement to return-to-work and quality-of-life issues. That's going to be what separates direct writers and their policies as to how they handle that and what they do. I also think we are seeing the entrance of managed-care players into the disability market. Nowadays, you're seeing the WC people develop an interest, and you're seeing some of the managed-health people starting to take an interest as well. These people have already been into managing the environment, and, because of that, I see the dynamics of the marketplace changing. As you get these other players coming into it, it's going to put a whole different focus on what we do to manage our clients.

Mr. Babino: Acquisition pricing is very aggressive and competitive. There's plenty of capacity out there, so not many companies are getting in the market. We see new players poking their heads in every once in a while. Some are staying; some are checking it out, feeling the water, and leaving. We're really not sure what's going to happen. There is some global competition—some foreign companies are getting involved in automatic disability reinsurance. As I look down the road, I

expect some consolidation. I'm not sure who it's going to be. I think most reinsurance companies, as well as direct writers, are out there trying to choose their partner before they're chosen for them. I know we're in that camp, and I expect that most others are as well. As I look at automatic disability reinsurance, I guess I could characterize it as being cautiously optimistic. I think we have a ways to go, but I think the trends are all headed in the right direction. We follow the fortunes of the direct-side market, which seems to be coming out of the woods. And so, I look for good things to happen in the next five years.

Mr. Gregory S. Benesh: You mentioned global competition. What about global reinsurance? What if some carriers wanted to get into other countries, can you help us in those areas?

Mr. Babino: The Smith Group is the underwriting manager for Sun Life in the U.S., and I do know that Sun Life does provide those services on an international basis. Smith Group cannot do that, but I know that Sun Life can.

Mr. Johnson: That's obviously something we have to look at for the future. Actually, one of our senior people is very interested in that area. But we haven't actually done anything at this point.

Mr. Lachance: We're basically limited to business in the U.S. and Canada. However, we have had some strategic discussions around setting up another facility that would be targeted for other marketplaces because of some interest that we have seen as well. But we're not there yet.

Mr. David S. Mogul: Jeff, you mentioned in your opening segment a couple of nonstandard disability reinsurance arrangements, and I was wondering if you or anyone else up there can talk a little bit more about both stop-loss and financial surplus relief as other methods of disability reinsurance.

Mr. Babino: We've quoted on a couple aggregate stop-loss deals. The problem with that is, where do you set the attachment point? Where's the co-insurance? Where's the corridor? But the biggest issue that we have is, when do you stop the experience? Although we've quoted on some, we've always been able to convince them to go into an automatic excess or quota-share arrangement. But we do have that ability. Again, for financial reinsurance, we depend on Steve Easson at Sun Life to price that for us. Sun Life has some offshore facilities that were able to come up with some surplus relief schemes that seemed to work pretty well.