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Session 119PD
What To Do With Older LTC Insurance Policies

Track: Long-Term Care

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Summary: Many insurers have one or more existing blocks of LTC insurance coverage. As products are revised, older policies are affected greatly.

MR. PHILIP J. BARACKMAN: In many ways, LTC insurance is a continuing experiment in product design, pricing and underwriting. By their nature, experiments result in outcomes of varying success or failure. Many LTC policies sold before the mid- to late-1990s, and even later, have left insurance companies dissatisfied with the financial performance. In some cases, policyholders have also become dissatisfied with outdated coverage since more comprehensive designs have become available.

Clearly, profitability issues such as high persistency and falling interest rates affect many older LTC policies. We're not going to ignore the subject of rate increases. Over the last year and a half, it's become very apparent that rate increases are being increasingly used as a strategy for dealing with older policies. However, the interesting point of this session is that there are other strategies to consider, either as alternatives or in combination. I want to emphasize that the purpose of the session is not to recommend any strategy as being some sort of panacea, but rather to expand your thinking.

There are no guarantees that what worked in one situation will necessarily work in another, but sometimes it's worth a try. I also want to say that it's all too easy to

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Note: The chart(s) referred to in the text can be found at the end of the manuscript.

characterize problematic books of business as mistakes and then start throwing stones from our glass houses. That's not what we're here to do this morning. If you don't have problem policies in your history with this business, then it may be because you haven't dug into the experience or are holding on too tightly to the original assumptions. And if you truly don't, then be thankful that you can learn vicariously from the rest of us.

One final point that I want to make is that today's new business is tomorrow's older policies. I think there's going to be continuing value in what the panelists have to say this morning.

Our first speaker is John Timmerberg, who's with Conseco. John has been working in the LTC industry for over 10 years with positions on both the financial reporting and pricing sides of the business. His current responsibilities at Conseco include in-force management of over $400 million of LTC premium.

Andrew Herman is a principal at Wakely Actuarial. He serves as vice-president and consulting actuary. He is responsible for overseeing the day-to-day operations of the firm and manages the firm's senior health consulting practice.

Mark Dinsmore is chief operating officer of LTC Global Solutions, a recently established company providing high-value-added financial, actuarial, marketing, underwriting, operational, informational technology and brokerage services to LTCI direct writers in insurance. Mark has operational responsibilities including management of LTC agent services. Mark has 10 years of LTC experience, primarily with Amex and GE. He's developed new, successful sales models, risk-based marketing programs and has provided risk analysis. Mark really is a rocket scientist. Prior to his insurance industry experience, he specialized in nuclear weapons safety and missile navigation. I have to feel good about having a real rocket scientist on the panel. Without further ado, John will lead off.

MR. JOHN LEO TIMMERBERG: Table 1 is an attention-grabber. What would you do with this? These are some actual loss ratios. Not all of our business looks like this. This is one block. But if you price to a lifetime loss ratio of 60 percent, and you get a 63 percent in the first duration, that's an easy one. You need to do something, maybe institute a rate increase. This is what I'm going to talk about.

Table 1

Duration	Actual Loss Ratio
1	63%
2	101%
3	125%
4	147%
5	172%
...	...
...	...

Potential rate increases should be evaluated beyond the most obvious situations like the one I just showed you. In the early durations, and sometime well beyond, there are many ways that poor experience can be masked or that experience may be difficult to evaluate. Do not rely on financials, statutory or GAAP, as the last word on anticipated lifetime profitability or loss ratios. Delaying the inevitable may have multiple negative consequences.

I'm going to go through three examples. If you have these kinds of loss ratios, you're going to do a rate increase. These are illustrations of how the mechanics work. This is where we were throughout the 1990s, as we were building our LTC business. The senior management mandate was, "You need to get to critical mass, thus covering your expenses and overhead." Everyone probably has had that mandate. You may have had aggressive rates. You may have had heaped and super-heaped commissions. Some of you may have been advancing commissions. With underwriting, you started out with the best of intentions. You had your underwriting guidelines, and then you may or may not have made concessions for various distributors or various special situations, et cetera.

Then there were marketing allowances. You may have priced at 10-15 percent first-year marketing allowances. Then you needed more money for direct mail or various other things. It seems like no matter where you work, there are distributors with clout, and they need or request a combination of some or all of the above. All of these are challenges to profitability. That's kind of a background as to how you may get into a situation where you need some rate increases.

When can we identify credible differences in early experience on the form? We have actual versus expected claims experience, policy terminations—both lapses and mortality, investment income, issue and maintenance expenses and the quality of the business. Is your underwriting really going to work the way you think it should? The mix of business is very important, by gender and marital status. What percentage of your business has inflation coverage? You also have to consider geographic mix. Do you have any area ratings? You probably should if you don't. Are you going to sell a lot in various sections of the country? Issue age is also important.

I gave a talk last year on gender and marital status. Marital status is worth, from our experience, about 50 percent. Married people have half the claims of single people. If you rank/order them by marital status and gender, married women have the fewest number of claims. Single women have the most, with the men layered in between.

I'll explain a baseline example from a form that we priced a couple of years ago using 2 percent-ultimate-voluntary lapse rates and '83 group annuity mortality (GAM). Claim costs were based on company experience. We discounted it 4.5 percent. Compared to the market, we had a relatively older issue-age distribution

because we decided not to pay renewal commissions on inflation riders. Usually it's common for your business 60 and under, to have inflation. The field doesn't want to sell that rider if you don't pay renewal commissions. We took that into account in our overall loss ratios. That's the baseline example. Table 2 shows what the loss ratios look like if we use those assumptions. The first four durations start out at 13 percent, going up to 33 percent at duration four. Then they cross over 60 percent at duration 10. And then you get your very high loss ratios that you get in the 20 and 30. I would think there's nothing unusual about that.

Table 2

Duration	Premium	Claims	Loss Ratio
1	1000	130	13%
2	920	184	20%
3	862	236	27%
4	815	269	33%
10	568	377	66%
20	234	366	156%
30	59	166	281%
		Lifetime	60%

Let's look at the impact of two experience deviations combined: attained-age claim costs end up being 10 percent higher than you expected, and your total annual lapse rate is 1 percent less than expected. You end up with a lifetime-anticipated loss ratio of 69 percent. So, if you had a 10 percent margin, you've essentially burned through your margin. Now you're at break-even, assuming the rest of those things on the list come in as expected, investment income, expenses, et cetera. I only changed two things, and we're at break-even.

Table 3 compares the original loss ratio filed in the actuarial memorandum against the new one that's going to develop with those two assumption modifications. There are small differences in the first four durations. At duration 10, you're looking at a 73 percent loss ratio versus 66 percent. I put the premiums out here so you can see that small differences in lapse rates start to build up. There's about a 10 percent difference in premium, and then by the time you get down to duration 20, you have 20 percent more premium than you planned on, and a higher loss ratio. That's how –the lapse rate and Actual/Expected incurred claim ratios over 1.00 interact to really get to you towards the end of the later policy durations.

Table 3

Duration	Original Premium	New Premium	Original LR	New LR
1	1000	1000	13%	14%
2	920	929	20%	22%
3	862	880	27%	30%
4	815	840	33%	36%
10	568	622	66%	73%
20	234	283	156%	172%
30	59	79	281%	309%

If you're going to re-target a 60 percent loss ratio, theoretically, under this illustration, one way to do that is to do two 15 percent rate increases at years six and eight to bring the lifetime loss ratio back to 60 percent. In this example, all the business was sold in one year. Then you just shut it down, and it's running off, just to make the example simple. Year six is duration six and calendar year six.

Why do you need to raise rates by 32.3 percent, given that you only had a 10 percent deviation in claim costs? For one thing, you have the lapse rates going on. Also, you had to wait. You probably couldn't find a credible difference until maybe at this point. Maybe it's still not clear. You can't go back and get premium from people for prior years, plus a lot of people have already lapsed, died and gone on claim. Policies have ended. You need a pretty substantial cumulative increase to make up for the small deviations.

This one clearly would be challenging to file. You have very small differences, which may or may not be credible. Once again, reviewing early experience, what is expected? How do we compare it to actual? You have your actual mix of business now versus your priced-for expectations.

MR. MARK S. DINSMORE: Now, the kind of policy we're thinking about is that we're going to customize offers to the individual policyholders. They're going to have a choice of paying about 50 percent more premium and having about a 10 percent daily benefit cut, or paying about the same premium they're currently paying and having about a 25 percent daily benefit cut, in exchange for adding this home health care that hadn't been there before. Based on our preliminary models, we expect a certain amount of anti-selection in the first couple of years, but we expect the whole block to return to profitability in about two years, given the conversion rates that we're presenting.

The sales process that we're imagining in this proposal is a direct contact to the customer from the home office. To start, it's going to be written, and then it's going to be followed up with phone calls to close the conversion. Our estimated cost at this point is somewhere between $250 and $300 per conversion to actually do this

close. We think that we should do reduced underwriting, primarily because we already have the risk. For lifetime policies, we don't feel that underwriting is necessary, except perhaps if there's a case in which we have some evidence that they are liable to use home care when they wouldn't use any facility benefits.

MR. TIMMERBERG: Mark, I'm the client. I have a question. My accountants and in-house actuaries are telling me we're going to get more cash if we just go ahead and institute a rate increase.

MR. DINSMORE: We have some projections at the tail end of this. In fact, it's going to show that you get more cash in the first year or two, but as lapses and deaths occur, there's a limited amount of extra premium that you're going to get from that. If you actually do the impact that we've seen done on claims, you're going to solve a lot of the problems that you see with a rate increase and having diminished returns. You're now at the point when any impact on claims is going to affect you exponentially going forward, whereas premium is going to affect you exponentially the other way, going forward. Yes, it's true that a rate increase isn't going to give you as much money.

The second reason that you'd want to pay attention to this is we actually think that you can get this program up and running a little bit more quickly than you can get a rate increase. You can follow it up with a rate increase on those people that remain as you get this implemented state to state.

That led to one of the things in terms of the communication plan. We've been through this before. The best way to handle this is on a state-by-state basis because then you can control the impact you have on your administration systems, call centers and new business, to make it an even flow. We think we should immediately let the policyholders know that we are filing for rate increases in their state, and then let them know that we will be contacting them with options that they'll have. On that contract you provide them with a mail contact and an 800 number that would probably be a separate 800 number from the standard, because it would be an attempt to close a sale. You'd bring it into a small sales department.

There are some options you could put in here. I don't think it's actually necessary, but it might improve your conversion. You could look at the tradeoff as, say, a five-year rate guarantee on this converted product. Again, one of the main sales points is that you're adding home health care to their policy. You'd follow up with phone calls and sales material. You probably would repeat the offer a second time when the rate increase actually goes through in that state so they have an option of two or three things to take, including the rate option.

One of the important issues with this is how you're going to deal with the agents. First of all, you're proceeding on a state-by-state basis again. You will inform the agents with policyholders affected probably by mail. You'll let them know that you're going to be offering this conversion and probably in that letter let them know

that you have to offer everybody in the class, and at least let them be notified of this offer. That's going to help when later you're actually making the sale on that group that you've intended to market to. The person who's going to make the call to the policyholder will first call the original writing agent. They're going to let them know that the policyholder is going to be contacted and assure them that there's going to be provided premium protection on their existing policy. Also, if there's a significant outburst from the writing agent, you allow them to have an opt-out feature—if you contact your policyholder, we will allow you to do that and try to make the conversion, but it has to be done. And then, of course, you would contact the agencies. That would be on a very personal piece-by-piece basis as you go through. Now Andrew's going to talk a little bit about what we see and what we have seen in the past in terms of financial impacts for this kind of program.

MR. HERMAN: Chart 1 illustrates the financial impact. The first part here is a premium comparison. If you don't have a rate increase, what happens to your base premium? Your base premium is just going to drop off due to lapses and deaths. In the case of a rate increase, you'll get more premium, so you'll get an initial increase, but then again your in-force premium will begin to drop. The middle situation is the conversion where you get some additional premium, but you're going to get the bigger benefit in the reduced claims. So, the premium comparison may be a little bit misleading if you just looked at that in isolation.

On the claim costs, you may get a little bit of a dip on the rate-increase scenario if you get some lapses due to the rate increase, but that's why the claims just might go down a little bit. On the conversion case, your claim costs are going to decrease substantially. The coverage amount is reduced, and, in particular, for people who didn't pay more premium, the coverage amount is reduced substantially, in our case by 25 percent. So the claims are affected substantially. Since these policies aren't at issue, and the claim-cost curve is steep and the premiums are level, you can see sort of a crossover here. As you get into the real tail of the claims, the conversion scenario's impact continues to grow, and it seems to be more profound.

MS. AMY PAHL: From a state or a regulatory perspective, is there an equity issue when you're filing for a rate increase? I'm assuming you're disclosing the possibility that you're going to do a conversion program. Does the state have some kind of requirement on the conversion program benefits, if you will, or there's an actuarial equivalent to the rate increase? What's the state's reaction to this kind of thing? If you're filing a rate increase, and then you don't implement it on everyone, you're treating your class in an inequitable fashion. How do you handle all those issues from a regulatory perspective?

MR. DINSMORE: There are issues that you will have to treat each policyholder equitably. My understanding at this point in terms of treating everybody equitably is everybody is informed and has the ability to do the conversion. So that will be done. In terms of integrating it with a rate increase, I will admit straight off I've never done that. I've done the conversion programs and have gotten very positive

results from policyholders, agents and regulatory agencies. I've talked to them in detail. I don't foresee there being an equity issue since everybody is essentially being treated the same by integrating the rate increase in there.

MR. HERMAN: There are probably a couple of things to be careful of. From the insurer's perspective, you really want to focus on the lifetime-benefit policies because those are the ones with the problems. But the offer needs to be made to the entire block, and, as a secondary issue, individual states may have their own requirements. I can actually just think of one offhand. I think in Florida there's a requirement that if you have a policy available, you can't just have a conversion policy available for some specific reason. Any product on the market has to be available to all potential customers. Clearly there are some state issues.

MR. DINSMORE: Yes, and that has occurred in a few states. However, there really isn't an issue with that if you're just not allowing commission to the agents, if they're not going to go out and sell it. So, it's not going to be something that hits you. There were actually a few states, and that was the way I've handled that in the past.

MS. PAHL: If I understand correctly, if you make the conversion the primary offer, and the rate increase becomes the alternative, then you don't believe that actual equivalence is going to be an issue with the states because you're offering them all the same thing?

MR. DINSMORE: Yes.

MS. PAHL: Is the product priced and developed specifically for this conversion program?

MR. DINSMORE: I think that there are a lot of advantages to doing it that way rather than offering an existing product. For instance, being able to tailor it without a lot of the bells and whistles can give you a 10-15 percent price advantage.

MS. PAHL: And then you're disclosing that to the regulator as your purpose for the policy?

MR. DINSMORE: Right, you disclose exactly how the policy was developed and what the features of the policy were.

MS. PAHL: My question is whether you disclose your intention on how you're going to sell it and market it.

MR. DINSMORE: Yes, you definitely disclose that the intention is that this is being developed specifically as a conversion product for existing policyholders, and you tell them the reasons and the intent.

MR. HERMAN: We have a second mock proposal, and this one is on commission buy-back programs. We're going to reverse course a little bit. Mark's going to lay out the scenario, and I'll present the proposal.

MR. DINSMORE: This is a fairly similar situation. We have a closed block of business. The morbidity is running as expected. The total block is about $50 million. It's about three to five years old. But there are a couple of things that have been problematic. One is because of the high lapse rates, and there's going to be a problem in the future. The company also offered a fairly high renewable commission rate of 15 percent and would like to cut expenses. Andrew has developed and is going to go through three possible proposals. The first is if there's capital available, just do a commission buy-back program for the agents. The second is if capital isn't available, you can do a buy-back program and blend that with a financial reinsurance program to try to bridge the capital gap, essentially borrowing the money. And then, finally, there's a possibility that you could buy the commissions and then resell them essentially at a profit, i.e., essentially become a middleman and brokerage the commission using your name and your contacts to make the offer.

MR. HERMAN: I've calculated present value of renewal commissions, and it's typically based on an agent request. An agent may want to receive cash in lieu of his stream of commissions. Clearly I perceive there is some interest on the part of agents to collect their money up-front. It seems that the whole proposal is viable, based on observations. In the first case, we're going to look at a situation in which a company has some capital available. Perhaps they don't have any new business. Maybe they've closed off the line for new sales. They are looking for investments with reasonable or high yields, and so the offer here is a payment to the agent in exchange for the rights to receive the future renewal commissions, and these are substantial.

In the example we've laid out, there's perhaps a 15 percent level commission rate which is going to generate quite an amount of commission over the lifetime of the coverage. These are still in the fairly early durations. The actuarial calculation would be to look at each agent's block and to look at the attributes, such as how old the block is. What is the issue age of the customers? Then you basically try to model the commission streams into the future with reasonable persistency assumptions and then discount back the stream of future renewals at a risk-adjusted interest rate, at perhaps the rate the insurer feels they need and that covers the extra risks.

There are some risks here of the business being moved. But, in any event, the actuarial calculation itself may be blended with simplicity because we're aware that the agents are probably incented to take a cash payment. So, three times the amount of in-force annual renewal commissions might not be particularly unattractive. In fact, it may be very attractive to an agent. For example, if there's a block of $50 million of annualized premium, it's paying 15 percent renewal

commissions. If we assume that the agents will accept on average three times the in-force commission, and we have a 40 percent conversion rate, when you multiply that all out it amounts to $9 million. That's really the capital investment a company would be looking at for this block.

The sale would occur when a company would contact each agent directly to make the buy-back offer. We really want to position this for the highest possible conversion rate. The company would then invest the capital and the purchase of these commission streams with the $9 million we talked about. One of the technical issues in this scenario is that you have an asset that's probably going to produce a very high yield, more than almost any investment you could make, but it's a non-admitted asset.

If capital's not readily available, we may look at an alternative to finance with the commissions as collateral. The company payments are lowered when financing terms are more favorable than the implicit rate of return on commission purchase. So the options are basically the same, except in the first option where the company finances the amount to purchase commission streams. In this case the company may be able to tailor the structure to deal with the non-admitted asset issue.

MR. TIMMERBERG: Andrew, I'm the client. I have a question. If I buy back these renewals, what's going to stop my agents from going out and replacing this business? Are there pluses and minuses to that situation if that occurs?

MR. HERMAN: Well, there's clearly risk, but if the block is five years old, it may be that saving the original issue age is more in the interest of the consumer, so that it may be hard to move the business. But this would probably be done best in a situation where there is some control on the agency force or there's been a relationship with the agency force. That's not a primary concern. The interest rate is going to be high, so that covers some of these risks. But if you suspect that's going to happen, this particular proposal may not be suitable for you.

MR. TIMMERBERG: I'd like to add a couple of things. First of all, it is very unlikely based on past history that you're going to get a lot of agents forcing conversions. The second thing is this whole project actually reduces your lapse risk because you're in a situation, especially after five years, where, yes, you have a lapse risk when you buy this, but you are already in an existing lapse risk if lapses are too low. This is actually a risk-mitigating strategy, at least in terms of lapse, not in terms of waiver of premium. So there are some issues with that. But with lapse and death, this actually lowers the company's overall exposures to movements.

MR. HERMAN: We have one more scenario here, and this one may, in fact, be the most attractive to a company where another company could resell reduced commissions. From the company's perspective the value appeared very favorable. It may be so favorable that there may be another party that would be willing to accept assignment of not the full commission amount, but maybe 80 percent of the

commissions. So, the finances may look attractive as an investment for a third party to accept, say, 12 percent of the 15 percent that's coming in renewal years, and then the company would get to keep 3 percent. Essentially, it results in an immediate expense savings, ignoring the drop-off of the business due to lapses and deaths. We calculated $600,000 annually in expense savings with the 40 percent conversion rate, and, again, that will drop down a little bit over time as policies drop, but that's a fairly substantial number. I think, Mark, you may want to comment on the feasibility of this and also your expectation of getting the 40 percent conversion rate.

MR. DINSMORE: In the talk that I will go to in just a second, there is a case study where there actually was a pilot done of 100 terminating agents, and the pilot got a 40 percent conversion rate. That seems fairly reasonable, and offers were in the 2.7 to 3.3 range, depending on the policies. On the other side, there are a few groups out there that are offering cash for commissions on a financial basis, and right now they have significant marketing expenses. They're going person to person, and there's a fair amount of extra work in that approach. Since they are offering right around the 3.0 range, it is very reasonable to get the recommendation from the insurance company and to reduce their expenses of actually marketing and going out and finding it. They would pay roughly the amounts that were given there.

Clearly, the numbers here depend very strongly on the S&P rating of the company or the A.M. Best rating of the company in terms of what people would give, because it's essentially debt to the company. The agent doesn't notice the difference. I think they might be noticing it now in some cases, the difference between a commission stream from one company versus the next, but finance companies will notice.

MR. BARACKMAN: One nuance is that if it does induce lapses, reserve is released on those policies. At some point that's going to be a better situation. The other point is that agents always have boat payments to make. So, even though this might not be entirely rational from an actuarial perspective, cash up-front is part of the appeal of this transaction.

MR. DINSMORE: What I have here is basically what to do with in-force policies. There are four categories that this gets placed in, and I have four case studies that I'm going to go through very quickly, especially the first two because you've essentially seen pieces of the first two. Then I'm going to go back to those four categories and talk about, again, just expanding your mind. These are concepts that you could think of in your business in terms of how to work on your in-force business in an original way.

The case studies are morbidity management. This is very close to what Andrew and I talked about except we didn't have any rate increase. There was an expense reduction through a commission-buy-back program that was a pilot. There have been some asset/liability programs. We actually have the expert, so I'm going to turn questions over to him. There were some swap programs done, and there are

some GIC programs that both simultaneously improved return and reduced interest-rate risk. And then, finally, there's a capital-management case study that used an offshore captive when you had a significant amount of margin. Obviously, if you did the buy-back program, you would have a significant amount of margin after you had done that, so that you can reduce your capital.

As for morbidity management, the situation was poorly performing indemnity. There was a certain segment in which claims were running at 150 percent of actual-to-expected for lifetime, and in certain cases it was actually running 200 percent actual-to-expected for about 23,000 total policyholders that were in that really high, poorly performing group. We developed a program that basically marketed to that group, an integrated policy basically at original issue age. Again, this was something that was available to everybody, but it was specifically marketed to a targeted group because that was where the profit and impact were going to be. Part of the reason that you'd market to them is the offer that was given was a 75 percent reduction in daily benefit, and it was really only suitable to those people who started out with high relative daily benefits. It was done with a direct sales model, with a home-office team, and it required very heavy communication with the field.

To give you a quick idea of what the results were, 9,000 of these 23,000 were converted. Overall experience significantly improved. There was a significant amount of anti-selection done in the offer. It turned out that actually was not necessarily a negative, because you looked at 100 sick people who said, "Oh, I can switch over to something that has a lower daily benefit so that I can get home care right now." What we found was that in the first year, the unconverted population actually significantly improved its performance because you had essentially taken out those very ill people that had been building up over the last 10 years and moved them to this converted policy. This was a surprise, as I did not expect this when I did it. The converted group actually did very poorly, but overall for the two groups in the first year, things balanced out to about the level of claims that we expected. It was slightly lower, and there was a slight advantage, because there was a little bit of extra premium that came in this program, but that was about it. By the end of the second year, however, things had gotten to the point where there was about a 15 percent overall claims reduction in the whole group. As you saw, 15 percent over time is probably a factor of three to four times what a rate increase would get you.

There are basic numbers to look at with the expense reduction and commission buy-back. There's a pilot that targeted 100 terminated agents, which I think actually will convert at a higher rate than active agents. Offers were between 2.7 and 3.3. This was an agent force that actually had a fairly low-end renewal commission rate. About 40 of the 100 opted for a lump-sum payment that was in the ranges above. The overall impact for the policies of those 100 was about a 1 percent of premium annualized expense reduction.

The investment programs that were done were very positive in the beginning as you're getting premium and not having claims, and then at the tail end you start having claims completely outweigh the premium that's coming in. The investment programs all rely on essentially the structure of this and a rising interest-rate curve.

You forward-invest the money that you know is coming in. When you forward-invest, you can actually get higher rates than what you could invest in today because you're climbing up the interest-rate curve. It depends on the curve, but, just as an example, if interest rates are 5 percent for a 10-year bond now, you can probably enter a forward swap. That would involve essentially agreeing to pay to get 6 percent starting in 10 years and going for 10 years forward.

The second thing that does for you is it locks in what you're going to get in 10 years for the investment that you are going to make in 10 years. Now I didn't explain that as well as I should, but that is essentially the program. There were two ways that this was done. One was with the forward-swaps rates that I just talked about. The other was to essentially sell very short-term GICs that you knew were going to be paid off with the premium that was coming in. If you are possibly in that market, you can sell those at a relatively low interest rate because it's on the short tail of the term structure. Two- to three-year interest rates are in the 2percent range right now. Then you take the money you got from GICs, and you invest it in long-term bonds for which you can get 6 percent. This is a way to actually front-load the money for you.

The results of that program were incredibly successful. Partly based on just the nature of the yield curve, it's estimated that the program, at the time that it was done, got about 100 basis points over the currently available investments. You locked in at about 100 basis points above what you would have been able to get in terms of the current market. It also locked in returns, and, since this was done, interest rates have dropped somewhere between 150 and 200 basis points. I don't know exactly where they are today, but they're somewhere around there. The company that did this has actually been completely protected for their old policies from the interest-rate drops that have hit pretty much everybody else. They locked in their profit, and when they look at interest rates going up and down, they just shrug their shoulders because it only affects what they sell today.

Another example of something that you can do is capital management where an offshore captive is used. First of all, you really have to verify that you have the margins in your business before you can do this. You need the experience analysis to make sure, as John was saying, that you know what the future is going to be, or at least as best you can, and that the actual-to-expected is going the way you think things are going. And then you use cash-flow testing to verify the margins.

There were multiple other tests that were made. Once that was done, an offshore captive reinsurer was built, and a segment of the business was taken and placed in

the captive. Among other things, in terms of the reserves, it eliminated the risk-based capital (RBC) requirement. The result was a leverage on equity of about 125 basis points of return. Even though the company was still on an LTC growth path, at that point they did not need any more capital infusion to continue to grow. They kept placing about 40 percent of new business into this offshore captive.

This was a very quick summarization of things that have actually been done, and the main reason I pointed them out was so that you could see the rough structure and the kinds of results that have been obtained.

Now this is really just blue sky. You sit down and you think, "How can I affect morbidity expenses, et cetera, in ways that can reduce my risk, increase my profitability, in ways that are creative?" For morbidity, I think there are two very critical items. You have to have very good experience analysis. You really have to know what's going on because most of the programs that I've seen or seen designed really utilize odd things in the experience that you'll see.

For instance, I have one in terms of an enhancement program that says add daily benefit. You sit down, and you figure you have 20,000 customers that you sold policies to two to three years ago. At first glance, you'd look at that and say, "Well, going back and selling them additional daily benefit is expensive. You don't get much sale for it, and it's risky." But, in fact, if you went down and did a detailed experience analysis on your policies, my guess is you'd find that utilization of your daily benefit is highly dependent on the level of that daily benefit.

In some of the experience analysis on very large blocks that I've seen—and this is in relative terms, it's going to vary by state—home health care might use $50 a day. An alternative-living-care facility might be $90, and a nursing home might be $130. So, if you sold somebody $100 worth of daily benefit, the next $10 might cost you less relatively to the first $100, and this is especially if they've gotten a buy-up like a benefit increase option or an inflation option, if they actually go into a nursing home. Since they had the options of going into a home-health-care situation or an alternative-living-care situation, this might be a very low-frequency event relative to the overall frequencies that you entailed.

So if you tailor and target it right, it can work. The other fact is it's going to be a while before somebody uses it simply because it's inflation-adjusted. There's reduced underwriting you can do on it. I'm just using this as an example because there are also things that you could do with zero-day-elimination period and so forth, but that really required a detailed experience analysis of your claims and the way that you're looking at your business in order to tailor these kinds of programs.

There are things that you can do with conversions upgrades that we've talked about before, and I think that there are a fair amount of claims management opportunities. I have a couple of examples. I've done a very detailed comparison of two blocks, one that had a zero-day elimination period for its home care and one

that didn't. What I found in terms of claims management is you can actually get in the door in a way that customers are happy with if you have a program that starts on day one.

If you have a zero-day elimination period, you can actually influence the way they spend their money. If you have a 20- or 100-day-elimination period, usually they already have services in place. Any attempt to influence the way they spend their money or the way they're taken care of is viewed as a strong intrusion by an insurance company because they have a doctor or a nurse, somebody they trust, who's already told them that this is what they really need. But if you're in there day one, you have a much stronger ability to get a lever in there and influence people.

I mentioned two programs regarding expanded asset/liability modeling . There are as many as there are derivatives in terms of the way that you can handle this. You can do things that are internal swaps with other insurance lines. There are some asset-reinsurance packages out there where, if you're a modest-sized company, you can basically hand it off to somebody else, and they'll do it for you.

You can actually use what Andrew was talking about in terms of the buy-back program as a way to levelize your commissions, because you can levelize your commissions and then have a finance company essentially buy the tail end of those commissions. So you have a package that goes to the agent looking pretty much like what you have now, but to the insurance company it looks like commissions are levelized. There are asset-reinsurance programs out there that basically combine with people that do the investment programs I'm talking about but tailor it like the GIC program, so a lot of the money comes in up-front.

Then there are some new pseudo-offshore-reinsurance programs that utilize various state regulations to essentially do what that offshore program that I mentioned before does. These programs can be combined. Although, as I mentioned when I was talking about it, it's very important that you make sure you have margin in the tail or else you're being irresponsible by doing this.

MR. JOHN A. HARTNEDY: I was watching particularly the actual-to-expected when it had to do with claims and lapses. What impact do you think that should have on reserves? I'm wondering whether reserves should be based on pricing assumptions and then adjusted —on a yearly basis based on your actual experience. That's part of my question, but the other one is: What impact do you think it should have on reserves when actual-to-expected is quite different?

MR. HERMAN: To some extent, there is some self-adjustment. If you have really low lapse rates, you'll be holding more reserves because the customers are in force, and you'll have it. But there are specific times and cases when you change your valuation basis, and I would suggest that you only do that if it's one of the particular situations defined in the accounting procedures or whatever the standards require. I think a lot of carriers would be most interested in doing a

gross-premium valuation and assuring that, with reasonable assumptions, there aren't losses expected on a statutory basis. If there were losses expected, I think you would have to change your reserve factors. But I think, by and large, the premium increase will help the performance of the business if you need a rate increase, and generally I'm finding carriers aren't changing their reserve factors, at least not on the first rate increase.

MR. JAMES M. ROBINSON: I have some concerns about the operation of the conversion options. I can see a whole range of different issues that might come up. For example, if you convince a 75-year-old female that she ought to drop her daily benefit limit by 25 percent and convert to a policy that now has home care, then five years from that point in time, she ends up in a nursing facility and would have received greater benefits under the old policy. What is the likelihood of litigation of one sort or another? And then, as a second part of this, if you've actually terminated or dropped the old policy, does the reinstatement provision still apply for the same period of time it would outside of a conversion, and so that you may end up with both policies being in force if something occurs in the short period of time after the conversion?

MR. DINSMORE: In response to the first question, I think that when you design the program and make the offers, you definitely think in terms of suitability. The target population in the actual program that I talked about was those people who had 120 percent of the average-local nursing home cost. It was a large population because it was from a large overall population. If you were going to a broader population, you would definitely try to put in offers that were up to the policyholder's choice that included ones that you thought were the most suitable, and that would be why you'd have a tendency to customize the offers.

Let's say a 75–year-old woman who had $120 of daily benefits switched to something that was like $95, and the average cost of a nursing home in that area was $130. Just to let you know, studies have been done that show that the average doesn't really mean anything with nursing home cost because you'll find one with $80, and you'll find one with $250. But there are a lot of scenarios where she's actually much better off because she gets money for home health care. She has that option, and in some cases you've added assisted-living facility. So, yes, I could come up with a scenario that could cause somebody heartburn, but in most cases, from everything that we've seen, it actually allows people to use their benefits more intelligently when they have choices. They're much better off, but you do want to make sure that you give them suitable options.

MR. ROBINSON: Yes, I certainly agree that probably on average you're okay, but I am wondering about this ratcheting effect that everybody who, looking back, might think they would have had better benefits under the old policy. Are there actually lawyers out there looking to track down these people and encourage them to file suit?

MR. BARACKMAN: I think one of the issues would be to present the offers or options without any special emphasis on the one that may end up being better for the company. "Marketing" should be spelled with a small "m."

Every time I've seen it done, it's disclosed all over the place. Just to let you know, when this conversion was done, we did a study of the people who claimed within 100 days. This fascinated me. There were a significant number of people out there that were really sick and had been really sick for years. They were certainly able to claim and just weren't claiming because they did not want to take the options that were available. These people suddenly had available sources of benefits that they didn't before. It was very interesting in terms of what happened.

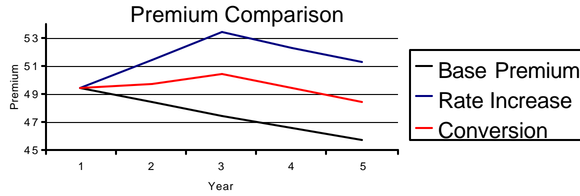
MR. GREGORY A. GURLIK: I was just wondering with the commission buy-back programs if you had any problems from regulators that have commission limitations in their state? Did you run into any concerns about this being kind of like the ultimate heaping of commissions in a way, depending how the program is put out there? Is it a one-time deal? Is it something that could influence where agents are selling their new business, because they're hoping six months from now they'll get the buy-back option? And did you run into any questions?

MR. DINSMORE: First of all, the pilot that was done was done with terminated agents that were well past the limitation periods that the states have. In the second case, most of my experience is as a third party or working things as a third party and not as the insurance company. It's going to be relatively minor because those are just a few states. You would definitely have to tailor it so that certain people could not do the buy-back within a certain period.

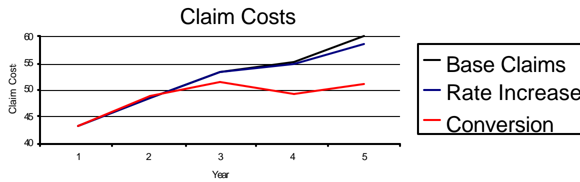
Chart 1

Financial Impact

Estimate ¼ of lifetime policies will convert to higher premium option, while 25% rate increase achieved in most states



Conversion impacts claims as well as premium, while rate increase has some added lapses



Conversion solutions increases impact as claims are expected to climb over time, while rate increase levels off except for residual lapse impact