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Session 65TS
Appraisals of Long-Term Disability and Life Waiver Blocks

Track: Health/Health Disability Income

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Summary: Instructors in this session address key considerations in deciding to buy or sell a block of long-term disability or life waiver claims; types of assumptions that are appropriate in determining the value of these blocks; ways the analysis of life waiver business differs from the analysis of long-term disability business; and possible structures for a deal. Attendees are exposed to the decision to buy or sell and the "how-to's" regarding the valuation of the business.

MR. DANIEL SKWIRE: I am a consulting actuary with Milliman USA. With me this morning is Peter Heinrichs. Mr. Heinrichs is associate actuary at The Hartford–GroupRe Plus. In addition, both Mr. Heinrichs and I work with a variety of different types of disability insurance and have had the opportunity to be involved in a number of reserve-buyout transactions.

We're going to talk about a few different topics this morning, beginning with a general introduction to the concept of reserve buyouts. Why would you pursue such a transaction, and what are some of the basic parameters of how these transactions are structured? Then we will talk about the importance, from the selling company's perspective, of preparing for a reserve buyout. What should you do ahead of time if you are interested in this kind of transaction, in order to make sure that you are getting the most possible value for your business?

We will move on to the purchaser's perspective of the pricing mechanics for reserve buyouts. And then finally, we'll address some of the consequences of the transactions, including the implementation issues that you have to deal with before you can finally close the books on these arrangements.

I would like to begin with just a brief description of what we mean when we are talking about claim-reserve buyouts here. The basic nature of the transaction is fairly simple. It consists of a direct-writing insurance company transferring the

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liability for a block of disability claims to another company, along with the assets that are necessary to fund the future payments for those claims. Therefore, it is laying off the liability and, at the same time, passing on the funds to make the payments.

Of course, there are a lot of different modifications. Sometimes this will be for a company's entire block of claims. Sometimes it will be just for one segment or another. It might be for claims that are older than a certain duration. It might be just for a certain line of business or one product or a segment of business that the company has exited for some reason.

On its face, this is a fairly simple type of reinsurance transaction. But in practice, the details can make things more complicated than they first appear. The good news for claim-reserve buyouts, however, is that these can very often be a win-win transaction for the selling company and the buying company. We're going to talk more in just a few minutes about why that's the case. But this really can be a very advantageous transaction on both sides, for many reasons.

And I think that explains why there's been a lot of recent activity in this market. There have been a lot of blocks moving back and forth between companies and reinsurers, and a lot of interest on the part of some direct-writing companies for doing these kinds of transactions.

There are a lot of reasons why a selling company might consider doing a reserve buyout. Disability, of course, is a very long-tail financial risk. When companies decide to exit disability, for whatever strategic considerations they may make that decision, they retain the liability for existing claimants on disability. And those claims can go on for a long time. If you're paying benefits to age 65 or even to lifetime, you might have that business on your book for 30, 40, 50 years, before all those claims are gone. Once you're out of the business, it's nice to be able to make a clean break and move forward with new areas of concern.

Claim-reserve buyouts can also be attractive for companies that have a small claims staff. Disability claims are tremendously complex to manage and adjudicate, much more so than other types of health-insurance claims. And there is certainly an economy of scale that occurs with the management of disability claims. Many of the companies that are most successful in this business have access to physicians, to lawyers, to CPAs, to all sorts of technical resources to help them manage claims. A small company may not be able to afford that kind of investment in their claims shop.

And a claim-reserve buyout is a way for them to access the expertise that may be brought to them by a larger claims organization and to get some financial benefit from that up front, by virtue of the transaction itself.

Also, insurers may be looking to redeploy some of their existing resources. Because

the company's priorities have changed, they may need to have people focused on an active product line instead of one that's been discontinued.

There are also some significant financial benefits to these transactions. Sometimes insurers in need of capital may have the opportunity to reduce the amount of risk-based capital backing their disability business by virtue of doing this kind of transaction. This is especially true, I think, on older blocks of business where there really is not a whole lot of volatility in the claims experience. But the risk-based-capital formulas do not distinguish between claims in early durations and later durations. They simply hold a percentage of reserves, so that may be an area where a company can free up some capital.

Finally, reserve buyouts are not restricted to direct-writing insurers as sellers. These do come up sometimes with self-insured employers who have their own disability plan and have built a block of disability claimants over the years. These are probably a little less common and tend to be an area that is more specialized. And you've got to have an employer who is savvy enough to understand the financial liabilities that he has. He needs to make some kind of provision in his financial statements for the present value of benefits, but it may not be funded in the same way that an insurance company would do this. Employers can be somewhat surprised when they find out that they have to write the reinsurer a check as part of this transaction.

There are a variety of different benefits to claim-reserve buyout transactions. Many of them are administrative in nature. One of the advantages for the seller is greater access to experienced claim managers and to the technical resources to manage disability claims in a more constructive fashion. That could be doctors, lawyers and accountants, who bring specialized expertise. But it might also just be the procedural and administrative experience of a larger and more experienced claims department.

For instance, the seller would be working with a department that knows that when you first get the claim, it's important to establish contact with the insured's physician. They know the right types of questions to ask in the first five days when a claim comes in. They know how to document a claim file. Some of these very basic administrative and procedural tasks can make an enormous difference in the performance of a claim block. And for a company that's not experienced in that area, this kind of transaction can help them get that experience through a partner.

It's also a way for them to devote some focused attention to a line of business that may not be part of the company's current strategy, especially if it's a business that they have exited. They can team up with a partner that really specializes in this precise business.

In the case of an employer considering selling a claim block, it gives them the opportunity to have claims adjudicated in a more impartial fashion by having arm's

length decisions made relating to the disabilities of their own employees. It's notoriously difficult to manage disability claims on your own employees.

There are administrative advantages for the buyer as well. There are some economies of scale in claims management. The larger the block, the more investment they can make, and the more ability they have to share resources to invest in a larger pool of technical experts to help them manage claims. In addition, the larger block of claims will help them improve their experience database. The more data they have, the better they are able to analyze their segments and spot trends in your business. This is particularly true in the later claim durations, where even large companies may not have a great deal of experience in how their business is performing.

Many of the benefits of these transactions are financial. And these show up in a number of different ways. One important one for the seller is the ability to get out from underneath what may be a redundant statutory reserve basis. Companies have different tables, of course, that they're using for their statutory reserves. But frequently, that's going to be a pretty conservative basis. The 1987 Group Table, which many companies are using, either in whole or in part, for their statutory reserves, is proving to be very conservative.

And depending on the exact structure of this transaction, this is a chance for the company to lay off that liability and get a somewhat more realistic basis set up for the reserves. And through the mechanics of the transaction price, the selling company will see some of that benefit.

As I mentioned before, the selling company may have an opportunity to release some of the required capital back into the disability business, which can be a significant benefit. In addition to the conservative morbidity basis, of course, statutory reserves are calculated using a conservative interest rate. And as part of this transaction, there may be an opportunity for the buyer to use a less-conservative interest rate, and for the seller to see some of that benefit in the price.

And finally, in the case of transactions that are performed with offshore reinsurance entities, there may be some tax savings. This would be the case, for example, if you are dealing with a reinsurer that is domiciled somewhere like Bermuda where there is no corporate income tax. But I would caution you that the tax implications are very complex. They are highly specific to the transaction, the structure of the transaction, the funding of the transaction, and the structure of the companies involved. So while this is something that's good to keep in mind if you're exploring such a transaction, you won't necessarily be able to predict exactly how this is going to work if you're going into this as the seller. The buyer is going to have to look very specifically at the transaction and their corporate structure. But if things work out right, you can see some benefit from this in the price that's offered for the transaction.

MR. PETER HEINRICHS: You also have to weigh the benefits of the offshore reinsurer's flexibility and investment policy and relatively lower/no taxation, with additional costs such as excise taxes, and various investment mechanisms—such as letters of credit and trust, which might be required for them to hold for you to take reserve credit.

MR. SKWIRE: I mentioned that reserve buyouts can be a win-win type of transaction, and I want to describe now why that's the case. In addition to some significant financial benefits for the seller, there can be financial benefits for the buyer in these transactions as well. One important one is the opportunity for the buyer to make a profit from a more favorable claim runoff than was anticipated in the reserves, and than may have been experienced by the selling company.

What I mean by a "runoff" here is simply the way the pattern of future paid claims develops relative to what was assumed in the reserves. That's a very important potential source of profits for the buyer, and one that a seller will often want to see reflected in the purchase price of these transactions.

As Mr. Heinrichs alluded, another attractive aspect of these transactions for the buyer is that they are going to receive a large infusion of cash as part of this transaction. They are taking on a liability, but they will be getting a large check or, in some cases, actual assets from the selling company. So that gives them an investment opportunity, and for a company that is very savvy on the investment side, that can create some profit opportunities. There are also various types of creative funding options that can be used for these transactions, including letters of credit and other types of funding vehicles.

Finally, we have already alluded a couple of times to the fact that administrative economies may provide more potential for savings on the part of the buyer.

But I want to talk specifically about some of the methods that a buyer of a claim block can use to improve the runoff of the claim business, that is, to try to achieve actual claim payments made to existing claimants in the future that are less than those that would have been experienced if the block had remained with the original direct-writing company.

A claim review is one of the most basic things that can be done. And this is often a matter of making sure that you have the right information on folks who are currently receiving disability benefits—making sure that the contractual provisions are being administered correctly, that the contracts are interpreted correctly. If there are requirements about the type of information that a claimant needs to provide to the company, then a claim review can confirm that the company, in fact, is going out and getting that information and is ensuring that people do remain disabled in order to receive payments.

A lot of this is procedural in nature, but if the disability business has not been a

primary strategic concern for a company, then they may not have given sufficient attention to some of these procedural items. A more experienced claims department may be able to come in and make some headway with a claim review.

Another option that a buyer has is to begin a settlement program. By a settlement, I mean the insurance company can offer a claimant a lump-sum payment in lieu of future monthly periodic payments. And that can be advantageous for a number of reasons.

Many claimants who are collecting $1,000 or $5,000 a month and who are not going to be recovering anytime soon because of the serious nature of their condition may prefer to have a large sum of money come in at one time to enable them to deal with current financial problems or get a different kind of care that they need for their condition, to get into a wholly different type of business, or to move—there could be all kinds of reasons why that's advantageous.

And for the insurance company, settlements can be beneficial because they relieve them of the ongoing claim management responsibility. But also, for a claimant who's not likely to either recover and return to work or to die any time soon, the company is essentially paying a life annuity at that point. And they may prefer just to be able to make a lump-sum payment and get the claim off their books.

Assisting claimants in getting approved for Social Security benefits is another possible advantage that the buyer can bring to this transaction. There is at least as much art as science in working with the Social Security Administration—being persistent in your appeals and that kind of thing. By following the right procedures, companies that are experienced at this have very high approval rates for Social Security claims on group disability blocks.

Whereas a company for which the business is not a key strategic line or that does not have a very experienced claim department may be getting much lower approvals from Social Security for their claimants. And since most group policies and some individual policies offset for Social Security benefits, there can be a significant reduction in claim payments due to higher approval rates.

Finally, a company that's very experienced in rehabilitation and return-to-work programs is simply going to be more successful in working with employers to get claimants back to work. And that can have a big impact on the runoff as well.

Now, here is a high-level example of how a claim reserve buyout looks financially. A direct-writing company might have a block of disability claims that has a current reserve of $50 million. And they might decide that they want to exit this business because it's no longer a part of their strategic fit. Since they really do not feel like dealing with the long-tail liability of these claims, they may try to do a claim-reserve buyout. So they'll start by sending some information around to reinsurers.

They will then get bids from potential buyers on how much money they need to receive from the seller in order to assume that entire claim liability. So the seller knows that the current reserve that they hold is $50 million. They know that they are going to get rid of the entire amount, but the question is how much they are going to have to pay to get rid of that.

In an ideal situation, they are going to have to pay something less than that reserve, so that they make a profit off this transaction. And maybe they get a bid that says, "For $45 million we'll take this $50 million liability off of your books." If that's the case, then the purchase price for the transaction is really $5 million. The buying company is essentially paying a ceding commission of $5 million to the selling company for the privilege of entering this business transaction. When I refer to a "purchase price" or to a "ceding commission," I mean the difference between the current reserve and the amount of assets that are transferred as part of the transaction.

Let's consider the balance-sheet impact for the selling company of a reserve-buyout transaction. At the start of the transaction, maybe their balance sheet shows a reserve of $50 million and required capital backing those claims of $2.5 million, giving total assets of $52.5 million.

Well, just by nature of how the transaction works, the company will be ceding the entire $50 million reserve liability to the reinsurer, so that goes to zero. Because the business is gone, they no longer need required capital to back that business, so that $2.5 million goes away.

But, whereas previously they had $52.5 million of assets, they have just negotiated a purchase price of $45 million. So they'll essentially write a check to the reinsurer for $45 million. But then they are left over with $7.5 million, which consists of the ceding commission of $5 million and the $2.5 million of required capital that they were able to release as part of that transaction.

One important footnote is that it's not always possible to see the entire benefit of this transaction on the day that it occurs. The risk-based capital is released, but if this transaction is done through a permanent coinsurance arrangement, then the ceding commission, which you can think of as the future profits on this claim block, has to be amortized over the remaining life of the block. So you need to do a little calculating there.

If this is done as a novation, that is to say assumption reinsurance, you can recognize that entire gain immediately.

MR. HEINRICHS: Yes, that is correct.

MR. SKWIRE: So there are pros and cons to the different types of reinsurance structures that can be used for this transaction. This is one consideration, but

another issue is that assumption transactions can be quite a bit more complex to try to work through at the time of the actual transaction.

MR. ROBERT MITCHELL: Could you go through what you think the accounting would be on self-insured buyouts versus direct-writer buyouts as far as the risk-based capital on the premium component?

In other words, if you were buying from a self-insured plan, in this same example that you gave, you would record the premium as $50 million, since it is a fully insured plan? How would you do that if you were buying it from a direct-writing company? I am curious about the impact on the risk-based capital.

In other words, if you're out there buying, as a reinsurer, self-insured blocks that have never been insured before, clearly, when you do a claim buyout, through the states, you have to pay a premium tax on that, the claim block. And I would assume that you would be accounting for that as a premium-income-type revenue, as opposed to just a balance sheet. And how would you do that when you are going with a direct-writing company.

MR. HEINRICHS: I would think that you're absolutely right. If you are buying out an employer block, in addition to having to pay premium tax, you would generally account for the reserve, the funding of it, as premium; it would have a distorting effect on your risk-based capital.

When you are buying out another insurer's liabilities, generally that does not go through as premium. However, depending on the rating agency surplus formulas, they may very well account for this as a one-time premium charge as well.

MR. SKWIRE: One of the important messages that we have for companies that are interested in participating in reserve buyouts, particularly for selling companies, is that a little bit of preparation can go a long way in getting set to do one of these transactions. You will get a better price for your business and you will get more value out of your business if you do some work ahead of time to prepare your block of business for the transaction.

And what I mean by "preparing the block for that transaction" is doing a little bit of math and a little bit of research about your existing claims and your existing reserves. It's important to do some validation of your current reserves.

What I mean by "reserve validation" is determining the precise liability that's going to be transferred to the purchaser of the business. You may be getting rid of all of your business, or you may just be working with a couple of segments. The segments of business that you're transferring may or may not have a perfectly clear relationship with how things are presented in your financial statements. You may have all kinds of different components of the business in your reserves that need to get split out or approximated or estimated.

The time to do this is before you solicit bids on the business, so that you know exactly what you're trying to transfer, so you can have some sense of what you're looking for in the price and how reasonable the offer that you're receiving is.

When a buyer looks at this block, they are probably going to be looking at a seriatim list of claims in an attempt to do a valuation and understand the price. So you want to make sure you can reconcile whatever seriatim list of claims and reserves you are putting together for your financial statements. And maybe that sounds somewhat obvious, but it is not always as easy as it sounds.

For some of these reasons, there could be many adjustments happening, and the segments might not line up. The management segments might not line up with the reporting segments. So again, the more you can clean up ahead of time, the easier it will be.

Understanding the adequacy of your reserves will help you to understand what type of price you will likely receive from a reinsurer. If your reserves are inadequate and your business is running off very poorly, then you need to consider that in terms of what you are looking for in a transaction. There are different reasons why the run-out could be poor. Some of them may affect the price for the buyout; some of them may not affect the price for the buyout. But you want to have a realistic expectation of what you are likely to achieve financially going into the transaction.

And finally, it's important to understand the effect of any other reinsurance that may exist on your business. Every reinsurance arrangement is a little bit different. Sometimes other reinsurance will remain in place when you do a claim-reserve buyout, and the buyout will be only for the portion of the business net of that reinsurance. Other times, it will go away. So when you're asking companies to bid on that business, you want to spell out clearly whether the existing reinsurance will stay or go and how you want them to treat that in preparing their proposals for you.

It's also critical to get your claims data cleaned up. Some databases are better than others, but most of them have some cleanup that can be done, and problems that exist can really get magnified at the time that you're trying to do a reinsurance transaction. And if there are a lot of problems in the data, those can make it almost impossible to get meaningful and consistent quotes on the business.

When cleaning up data, there are all kinds of different things that need to happen. As I mentioned, a buyer is going to want to see a seriatim claim listing so that they can do a valuation. They don't necessarily want to see the same seriatim listing that you use for your reserve system. It might have a lot of codes that look like "X13" and "B24" and don't mean a whole lot to them. It might have all kinds of fields that simply aren't needed. It might not have certain kinds of fields that they're going to need.

You may know, for example, that the elimination period on all policies that begin with the letter "Y" is seven days. But the reinsurer isn't necessarily going to know that. So if you can clean up that file a little bit, format it in a clear fashion, give them information on how to decode the data, and make sure that they have the key fields, it's going to make things go a lot more simply.

One problem that frequently comes up is that a lot of closed claims remain on the list. You really don't want that if you're a selling company, because if you've got a closed claim on your list and it looks like it's open, you're going to be paying the reinsurer to take that claim off of your hands, and the claim is already gone.

You also need to search for bad data or missing data that may be on your seriatim claim list. Sometimes there are missing data, and there's nothing that you can do about that. And in that case, what you need to do is specify to somebody who is looking at the block what assumptions they could use. For instance, if you've got a segment of the business that for some reason didn't get the gender recorded on the claims, you may not be able to do anything about that. But if you're soliciting bids, tell the reinsurers what you'd like them to assume. Is it a block of teachers, and should they assume that it is all female? Is it a block of construction workers that they should assume is all male? Give them some sense of how you'd like them to do it, so you can be sure you're getting consistent answers from all the different companies looking at the block.

Mr. Heinrichs and I put our heads together here, and we were swapping war stories about different claim files that we've seen and some of the problems that we'd run into with claim data. Here are common data issues that we have run into while looking at claim files:

- Male pregnancy claims
- Claims whose claim duration exceeds the benefit period
- Net benefits not equal to gross benefits less offsets
- High reserve factors relative to the number of remaining payments.

If you're a seller of a claim block, it's a good idea to estimate a target price that you might receive for your business, and one of the things that you clearly want to do is work from a clean data file. Try to look at your business as if you were an outsider looking in. So work off that cleaned-up seriatim file that you're preparing for the reinsurer. You might want to try revaluing your block with some kind of industry experience and a current investment yield.

Having said that, though, it is important to consider your own experience on this block of business, and what the underlying causes of that experience are. For example, if your block is running out poorly relative to your reserves, there are different reasons it might be running out poorly.

If it's running out poorly because your entire claims department has quit and you've

got one poor overworked person who is serving as a check writer—just sending out benefit checks—then your run-out is going to be poor. But that's something that a buyer of the block is going to be able to resolve. They are going to be able to put in the right kinds of procedures, and they might reasonably assume they will have significantly better experience. So when they price that transaction, they're not necessarily going to look at how the block is performing under loose claims management. They'll look at what they could do with that block if they had it.

On the other hand, if the problem with your business is that you're paying some unusually rich benefits, like lifetime benefit periods, and specialty own occupation with cost-of-living increases, and you write only $30,000 a month in benefits to physicians, in that case there may not be a whole lot the reinsurer can do. And that's going to be reflected in the bid that they can give you. It doesn't mean that you don't want to get the business off your hands, but it means you might have to pay a little more than you otherwise would have anticipated.

And finally, when you're looking at the price, there are some other details to consider. You need to include the expense reserves, assuming that the reinsurer is going to take on claim-management responsibility. The cost is coming out of their pocket, so you will also be transferring them a claim-expense liability, and you will need to compensate them for that as well.

And, of course, reinsurers are trying to make a profit on the transaction. This may not show up explicitly, but it's part of the pricing method that they go through.

The final comment I'll make in terms of preparing for the transaction is that claim-reserve buyouts are almost uniformly subject to a due-diligence process. If you're preparing for this, you should expect an onsite visit from the reinsurer that's going to assume the business. They'll want to meet with your claim staff and understand how the business is administered. They'll want to be able to come and talk to your actuaries about reserving issues. They're probably going to ask to pull some claim files so they can look at the kind of information that you have.

And at the same time, there should be a lot of questions that you have for them. If they are assuming responsibility for this block, they are going to be working very closely with your customers, and, in a way, they are representing your company in paying these benefits. Therefore, you want to be very comfortable with their level of experience and professionalism, with the degree of administrative services that they can perform for you. So you'll want to do your own due diligence on the partner that you're going to be working with on this transaction.

Are there any other comments from anyone on the types of preparation that are necessary for these transactions?

MR. RICHARD LEAVITT: I just wanted to comment—and this is more from the point of view of the buyer than the seller—that probably the biggest data issue that

I've seen is that benefit amounts don't match what's actually being paid out. And that's a tough one to get a handle on, because often you just have the open claim listing with an amount, which you just have to believe.

I ask for, although often don't get, information on the actual recent payments made. But that's the one thing that just seems to be the most prevalent. The example of the gross and the offset not matching happens all the time. And that's just one thing to pay attention to.

Cost-of-living adjustments are the other thing that can get you, because if that's not properly identified, that can be a huge difference in the liability.

MR. SKWIRE: Those are good points. That is the type of thing that a buyer will be looking for as part of the due-diligence process.

MR. HEINRICHS: I'm going to talk about the mechanics of pricing these reserve buyouts. Pricing a reserve buyout is pretty simple. Your cash inflows have to be greater than your cash outflows. What's sobering, though, is that you're projecting claim payments for a very long period of time, well over 40 years. You're also projecting the expenses of paying those claims, and you get to price this thing only once. If your price is wrong, you have to live with it.

In pricing these buyouts, there are a few methods that you could use. Probably the more complicated one is to actually model cash flows. And that's not just modeling claim payments at each point in time, but also expense payments at each point in time, future reserve projections, future invested assets, future investment returns and future taxes.

So essentially, it's projecting your income statement until the last claim has been paid and either doing a present value of profits or determining the price it gives you for your internal rate of return. That's probably the more accurate method. It's also one of the more time-consuming and complicated methods.

Another one that's in common practice is to calculate present values and perform formulas off those. So really focus on the net single premium and the statutory reserves and tax reserves as of the time of the valuation date.

And lastly, another method, which is fairly crude, is to use ad hoc percentages of, say, group premium waiver of face amounts or the reserves held by the prospective client.

Now, although each of those three methods are very different from one another, combinations of these can be used in pricing. You may use a cash-flow model to determine the initial price. And for late-reported claims or for true-ups, you might use a percentage of the reserve held by the client, which is determined by your price from the cash-flow modeling. So these aren't necessarily mutually exclusive,

and each may have a time and a place.

Once you've determined your price through this or another method, you then have to determine how you want to express your price. Are you going to give them an absolute dollar amount for identified claims: say, "For these 100 claims, we'll charge you $10 million." Or do you want to make it so that "We'll charge you 85 percent of the reserves you're holding." Those are two common ways to release the quote.

There are some related questions there, though. First, when you're pricing this, you will be given a data file at a particular valuation date, and you will be pricing this for an effective date, which is generally at a later point in time. So your data will change between those time periods. People may recover, people may have some earnings that change the offsets, or an offset might go away. The data could become wrong or may have been wrong in the first place.

So the question then is what mechanism you have to deal with those changes. You may have a reconciliation process whereby you essentially determine the price on one basis, recalculate reserves with the data file as the effective date, and that is what drives the price changes. The question is whether those price changes are done on the basis of the initial pricing, or whether reflecting the changes in the data will require you to actually change the pricing basis.

It's kind of a complicated matter, and it is pretty important that you have an understanding and an agreement between your organization and the ceding company, so that you have mutual expectations as to how this issue will be dealt with.

In terms of offering a price as a percentage of a reserve, either using what's held by a client or using a standard table, there's really not a publicly available benchmark for a premium waiver or for disability that will reflect your precise pricing needs. For example, if you are going to use a benchmark approach, no benchmark may adequately reflect the actual diagnoses of the claim block. So you may have a pricing risk for true-ups if you use a benchmark. So if your diagnoses shift in a way not contemplated by the benchmark, you could be left out in the cold.

Another big question is the issue of reconciliation. It's a very important process because, as a reinsurer, it keeps you from having to ascertain the adequacy of the data in perfect detail. But it can also be rather thorny in terms of the discussion of what was a data error and what was not.

You may wish to consider, if there are significant data errors, whether or not you even wish to release a price. As a practical matter, the treaty in your agreement might say that you can reconcile as you need to. But you may have a real problem if the data errors are so significant that you've charged a client $20 million for a reserve buyout, and you need to collect $5 million in reconciliation. It may be an

issue, and you may wish to avoid that process.

In terms of the investment income, you will be collecting your interest on the reserves and on surplus. And you have to determine how you're going to be crediting and earning these investment incomes—what reserve-valuation basis will be used, what investment returns will be realized, what your investment strategy is, and what assets that you will use to support and fund this transaction.

And there is a difference, of course, between whether you are an onshore reinsurer or an offshore reinsurer, because of the differences in the investment restrictions. One thing that's interesting, though, is that at times it may not be as great as you think, just because of the duration of the liabilities. The average duration of a long-term disability claim is about four to six years, premium waiver—depending on the block—six to eight. Only you can decide whether an offshore investment strategy would make a material difference.

Also, there is the issue of investment expenses; whether or not, say, it's required by your client, by virtue by being an offshore reinsurer, to have a letter of credit or put assets in a trust for those types of expenses. And in addition to having the expenses that you know about, since you're talking about a very long-tailed line, if you're using a letter of credit, you'll have to predict the availability and costs of letters of credit for about 40 years. It's a pretty daunting task.

In terms of projecting claims, on the long-term disability side, there's the old 1985 Commissioners Individual Disability Table A, the less old 1987 Group Long-Term Disability Table, and the somewhat problematic 1995 table—all of which, perhaps, don't really reflect the breadth of diagnoses affecting disability claims. Of course, various insurers with large databases have their own proprietary tables as well, based on their experience.

MR. SKWIRE: And some of that is going to depend on the specific nature of the block that you are assuming, too. The business that you acquire in one of these transactions may or may not perform exactly like the business that you currently have on your books. It may be an older block with less opportunity for improvement, or it may be a block that has a lot of room for improvement and initially will perform better. So all of that needs to be reflected as well.

MR. HEINRICHS: The options in pricing premium waiver buyouts are much fewer. You basically have the Krieger table and multiples of that. Or if you're fortunate, you may have a proprietary table. The Krieger table, I think, is widely believed to be extremely conservative. I would concur with that, but there is a tremendous variation in terms of people's views as to how it is conservative.

MS. SUSAN SAMES: I'm the chair of the group life experience study committee, and we are looking at doing an update to Krieger, provided that we can get enough participation from direct carriers.

MR. HEINRICHS: Fantastic, and so maybe in a year or so we may have another option.

MS. SAMES: We are working on requirements for that right now. And probably early this fall, we will be getting those out to people.

MR. HEINRICHS: Great, so we'll certainly change the dynamic when the Krieger takes its long-needed nap.

In terms of claim payments, you've got to determine, whatever basis you chose, how you're going to tailor this for your claim-management strategy. Do you believe that, based on the carrier's past treatment of these claims, there's a possibility for additional terminations over and above what's assumed in your pricing basis?

Or perhaps the converse may be true. There may be particularly hampering features in the policies, and you may have fewer terminations than you expect. Or do you believe that there's opportunity to have more offsets than are currently realized? Those are certainly assumptions that you will need to make, since you are trying to create the most accurate estimate of the future of claims.

There is also the consideration of additional benefits. They are generally smaller in terms of the costs of these buyouts.

On the premium-waiver side, how do you deal with dependent premium waiver? Generally it's smaller, but it is out there.

On the disability side, how are you going to deal with survivor income benefits?

And again, generally on the premium waiver side, are you, as reinsurer, going to take the responsibility for conversions on these premium-waiver claims when they are no longer eligible for benefits? Or is that something that you're going to leave the direct carrier with responsibility for? These are things that need to be determined during the pricing process and during the treaty process.

Expenses are generally the second largest item in pricing these reserve buyouts. You'll have your setup expenses, anything you'll need to do to initialize your systems to deal with the influx of claims and policy information that will come if you're successful in acquiring the buyout.

There is also the cost of adjudicating claims—your staff, your claims staff, your cost for independent medical exams, your cost for other medical records—you'll have to make provision for all of these items in the pricing.

It is important to figure in a provision for your pricing expense, the time that you are spending calculating this. It's not necessarily insignificant. If the data are bad, if there's a lengthy cleanup process, you might find that you're spending a fair

amount of time on this. Furthermore, you need to look at this in terms of what your close ratios on these deals are. Because with each one that you close, you need to make provision for the number that you do not close but have already incurred expenses on.

Your acquisition expenses are also a concern, whether you have a direct sales force and you have to make provision for paying them for these buyouts, or you're using brokers who will expect to be compensated with either a percentage of the reserves itself or a percentage of the reserve release. Either way, that has to be put into the price.

Inflation certainly affects everything. You will have to include that and guess what inflation will be 20 years from now. Also, you have to determine on all items whether you will be using in-house resources or a third-party administrator (TPA). That can affect the pricing on claims. Depending on what kind of guarantee you may have from a TPA, that will affect your claims management.

I will talk briefly about taxes. You have to figure your tax reserves as if you are using the cash-flow method. And you also have to figure how you're going to amortize and capitalize various expense items. You have to determine whether deferred acquisition cost taxes apply. And if you're going to use an offshore mechanism, you'll have to view the complexities of offshore taxation and accounting, which, I must admit, I'm not an expert in, but I know there's an excise tax that you'd have to figure into your pricing.

You will certainly want to make money off of this too. Your shareholders will be rather upset if you're engaging in this for free. So you have to determine what your target returns are and whether you want to make a provision for contingencies, since you are making some very long-term bets.

In terms of determining a profit, you have to determine whether you are going to use the internal-rate-of-return approach or return on equity. Part of that may be driven also by the method you are using. You might prefer to use an internal rate of return if you are using the cash-flow method. You may prefer a return-on-equity approach if you are using present values. And in your projections, you have to determine whether you wish to use best-estimate cash flows or throw some margin in there, again recognizing the long-term bet. All of these things vary widely by company.

MR. SKWIRE: Well, as you probably gathered from our comments so far, there are some complicating aspects to these transactions. And we're going to talk in a little more detail now about a few of the implementation issues that are connected with finalizing one of these transactions.

There is a standard timeline for putting together one of these transactions. One of the first important things is the bid date. When you are looking for quotes from

prospective buyers, you will send them the information, and you will want them to get back to you with a bid for the price for the business.

In order to get that information, you'll have to specify to them what valuation date to assume when they're calculating reserves. That might sound obvious, but it is important to specify that, because it is not necessarily the date of the claim file. And if you don't specify it, you might have five different companies giving you bids at different valuation dates. It's going to be a little hard to compare the quotes that you're getting.

Eventually you will get the bids back from the companies, and you will do your own analysis of those. And there may be some back and forth, you may have updated data, you may resolve some issues, and so on. But at some point, you'll be able to make your final decision on which company is going to be purchasing this business from you. And at that time, you'll agree on what the effective date for the transaction is going to be. Probably that's going to be a different date than your initial valuation date, although everything here is subject to discussion and negotiation.

The effective date is the basis for the final reserve calculations and the final list of claims that will be involved in the transaction. There's then going to be some kind of lag between the effective date and the actual closing date of the transaction, during which you're hammering down the last few details. And then at the closing date will come the actual asset transfer, where you're cutting the check to the buyer to fund the reserve to take care of the price that you agree on.

And then over the following months, there are going to be a number of different things that happen, assuming that a company is managing claims for you. There is going to be a big process to transfer claim files to the new administrator. And there will be some final settlement dates down the road where you true up for any kind of information that became known after the transaction occurred or after the price was agreed on.

It's important to recognize that the price of the transaction may need to be adjusted at various times between the bid date and the closing date. There will be new information coming in on claims that closed or opened, or on payments that have been made since then, for example. You have to consider whether you are making the transfer to the buyer in cash or in securities. That will get established fairly early on, because the buyer is going to want to know that as part of their bid; that's going to affect the price that they can offer you for the business.

There should also be some kind of documented procedure for dealing with interest-rate changes all through this timeline. This is an issue up until the assets are actually transferred, because interest rates can change significantly over short periods of time. And even small changes can have a big impact on profitability for the volume of assets being transferred. You'll need to make sure that's spelled out,

so that one party is not assuming that there's a guarantee where none exists.

Incurred but not reported (IBNR) claims are a very important issue in buyouts. There are a couple of different ways that they can be handled. Assume, first of all, that the company that's selling the business has a tabular claim reserve or present-value future payments on claims they know about of $50 million.

They've probably got some provision out there—they'd better have some provision out there—for claims that have been incurred but not yet reported as of the specified valuation date. And maybe that's $10 million. But, of course, that's just an estimate. The very nature of this reserve is for claims that we do not know about yet, so the actual amount of IBNR claims can't be known at the time that this transaction is actually done.

So that is a risk that one or the other party in this transaction is going to have to bear. And there are two different ways that this is commonly handled. One is for the selling company to maintain the IBNR reserve that they already have. And after the effective date of the transaction, as new claims are reported that were incurred prior to the effective date, those claims will get transferred to the buyer. But there will have to be some kind of agreed-upon basis for how much money is transferred along with that claim. And that's what Mr. Heinrichs was saying, often there's an estimate. You might just agree that it's 90 percent of the reserve the company was holding or whatever the figure may be—something consistent with the pricing of the transaction.

The other method that can be used here is for the buyer of the business to assume the IBNR liability, as well as some funds to support that. So in that case, the seller is going to transfer some extra cash to the buyer in order to fund those IBNR claims. And the buyer takes on the risk that the actual IBNR claims that come in the future are going to be either higher or lower than that reserve. That's obviously going to require a little extra diligence on the part of the buyer to make sure that they're comfortable with the IBNR basis that was used to figure out how much money was going to be transferred.

So those are typically the ways that this kind of thing is handled. This can apply not just to IBNR, but also to reopened, claims, and to terminated but not reported claims. It really applies to all sorts of new information that you get after the time of the effective date.

MR. HEINRICHS: I will just add to that another option for you as a reinsurer is to use a combination of the two. You might decide that if you are doing this transaction as of January 1, you wish to use one method for IBNR claims for the first three months of run-out. And then you may be more comfortable with the remaining IBNR reserves, and the actuary will provide a specific price. As in all things in reinsurance, there are many options, one can be very flexible, and there is really no cut-and-dried way of approaching these items.

I'll talk about some last consequences with buyouts, but I'll talk about these rather quickly because I would like to leave some time for additional questions.

Accounting has been brought up as a consideration here and, by all means, is rather important. A key issue is the timing of recognition of income. There are GAAP standards on that, which essentially mean that you cannot have an immediate recognition of all of the reserve release, unless you're using assumption reinsurance, because there's always the risk of your reinsurer defaulting and those claims and liabilities becoming yours again.

Your accountants and auditors will have to determine—particularly if you're keeping a portion of the risk—whether, for statutory accounting, you can use the reinsurer's reserve basis for these claims, or if you have to treat that as a change of basis. You have to determine your views on whether there is a requirement on mirror reserving for these clients. This, again, may affect the issues of statutory accounting changing bases.

And then, of course, there is the practical issue of where the claim administration is being performed. If your reinsurer is managing claims, and you will have set your own reserves, you'll have to have a data field to give you reserving data that you previously had. That can be something that is important to spell out early in the process.

In terms of claims, there are many considerations, particularly if your reinsurer is managing claims. And on the implementation side, you physically have to get the files to the reinsurer, who has to review these files and put them in their systems. That is a fairly time-consuming task.

You have to determine whether you, your reinsurer or a TPA will adjudicate claims. That can affect both workflows and pricing. If your organization is no longer managing claims, but another party is, you may want to set service standards. You have to determine how to deal with reopened claims or contested claims or claims in litigation. It may be wise, given the great uncertainty of litigation results, for you to retain those liabilities until the litigation has been resolved.

You have to determine the issues of fiduciary responsibilities. Is your reinsurer a fiduciary now? Who's going to file those required fraud reports with each state? And how are you going to deal with overpayments and underpayments—particularly those that spread to the period before the effective date?

In terms of underpayments, your reinsurer or TPA may determine there's a liability. Well, if there is a $50,000 liability, and $40,000 of that is before the effective date, are you expecting to pay your reinsurer the $40,000, is that part of the reinsurer's pricing? It's certainly something that you need to discuss early in the process.

You will also have to negotiate a reinsurance treaty, which is always a very fun

process. In that treaty you will have to determine the reconciliation language, which makes it even more enjoyable because it is highly technical and highly mathematical. If there is a reconciliation to data provided, you'll have to specify in the treaty what pricing information you provided. Is it the e-mail from John Smith to Nancy Bates on April 4th, or are you going to actually include the entire file in the treaty?

You will have to determine how you will deal with disagreements that may arise. Are you going to have an arbitration mechanism? Or, particularly for numerical disagreements, are you comfortable using an independent actuary as arbiter of the difference to deal with that appraisal?

The documentation and legal issues are quite significant with assumption reinsurance, over and above those presented by coinsurance. Required statutory approvals and required policyholder notifications make a rather lengthy and perhaps expensive process.

You have to determine whether you will need financial-security measures. Will you want to reassume these claims if your reinsurer's rating drops below a certain level or other things happen? That might give a reinsurer some pause, but you have to determine what you'd like.

MR. SKWIRE: I want to touch on one of the pricing issues that we alluded to, but didn't fully address. And this goes back to the question connected with some of the risk-based-capital treatment on the transactions.

One of the important things to consider in finalizing these transactions is where there might be some asymmetry in the financial positions of the buyer and the seller. If you're doing a claim-reserve buyout, and it's Hartford Insurance working with Hartford Reinsurance, then you can be confident that you have pretty good information about the company's relative positions, and they understand all those dynamics.

But when you're dealing with a domestic company and an offshore company, when you're dealing with an employer to a direct writer or an employer to a reinsurer, or all kinds of other situations, then there are going to be some significant differences—from risk-based capital to taxes, to reserve bases, to the way that assets are invested. And they may not always be readily apparent, but they can have some very significant impacts on the financial outcomes of these transactions.

And I think it speaks to the benefit of the cash-flow-pricing approach that Mr. Heinrichs alluded to. If you are beginning to do some of these transactions, particularly to assume business, you want to make sure that you are thinking all those things through. This isn't quite as simple as just running a bunch of claims through your reserve system and agreeing on the price.

You need to make sure that you're not getting blindsided by some of these other tax and capital issues, so I think that's a very good point. Thanks for bringing that up. Are there any other questions or comments?

MR. ANDREW DETICH: I just want to ask, in the pricing of these transactions, do you make any allowance for claims that are reported but haven't finished going through the waiting period yet, for the possibility of the claim not actually making it through?

MR. HEINRICHS: There are a couple of approaches there. One would be to put a factor in the pricing, either in cash flows or in the present value, for those claims. Another approach, which I think would be more common, would be that pending claims are excluded until they are approved. That gets rid of some of the uncertainty with those claims and reduces an element of gaming in the transaction.

MR. SKWIRE: It is somewhat similar to the IBNR issue. One party or the other assumes the risk that the actual approval rate is going to be different from an assumption. So it's just a question of which way that goes.

FROM THE FLOOR: Which of the two formats has been more commonly used in your own observations, the assumption or the permanent coinsurance?

MR. HEINRICHS: In general, I would say the permanent coinsurance, because of the simplicity and the minimal regulatory concerns. That being said, I have seen an uptick in the use of assumption reinsurance. And it certainly depends on the motivation of the ceding company. If the goal is to completely exit the group line, or if it's a company in rehabilitation, there generally isn't an alternative to assumption reinsurance. If they are, say, just getting transferred a portion of the reserves, then generally coinsurance may make more sense.

FROM THE FLOOR: Does the claimant have any say on assumption reinsurance?

MR. HEINRICHS: Perhaps in a few jurisdictions. But for the most part, they just receive notification. It varies dramatically by jurisdiction. But interestingly enough, in most instances, there seems to be very little in the way of questions and, certainly, objections.

FROM THE FLOOR: So even if you can't take an immediate tax benefit, the labor involved in an assumption is very considerable?

MR. HEINRICHS: It is considerable. It is time consuming, and there is always the risk that you may still have a coinsurance agreement—at least for that handful of claims that say, "No, I don't want to be taken over by your company."