RECORD, Volume 29, No. 3*

Orlando Annual Meeting
October 26–29, 2003

Session 86PD
The Long-Term-Care Insurance Business: Risk and Historical Perspective

Track: Long-Term Care

Moderator: MARK D. NEWTON
Panelists: STEVEN J. MANNIK
JAY NEWMAN†
LARRY H. RUBIN

Summary: Designed for management or actuaries involved with strategic planning, the topics include product and pricing evolution, position in the product life cycle, requirements for success and options for entering the marketplace. Attendees learn risks and opportunities in today's marketplace, how the range of stand-alone and combination products can meet needs of different market segments, and considerations for entering the market.

MR. MARK NEWTON: Welcome to "The Long-Term-Care Insurance Business: Risk and Historical Perspective." We spent a lot of time thinking about what this session should be about because in long-term care we tend to focus on details. We tend to focus on the "how-to's" in very actuarial aspects of long-term care. We hardly ever get the chance to think about long-term care in general or even the long-term-care industry. We hardly even focus beyond insurance to what we do as business people, as opposed to what we do as long-term-care actuaries. The purpose of this session today is to step back and think about our view of long-term care from a business and risk perspective. The panel that we've put together consists of people who have an alternate view of the world, a not-so-detail-focused view of long-term care but a much more general focus.

†Mr. Jay Newman, not a member of the sponsoring organizations, is principal at Los Angeles Business Capital in Beverly Hills, Calif.

Larry Rubin is managing director of Bear Stearns. He works all over the insurance industry to create asset strategies focusing on particular risks of long-term-care insurance. As an investment banker, I know his view of the world has changed over the last few years. He has a unique perspective as a long-term-care actuary but also as an investment banker and someone who's spent some time in the capital markets, which definitely is a different view of the world than we have as long-term-care actuaries.

Jay Newman has his own firm, Los Angeles Business Capital, which he founded in 1995. He develops directly negotiated venture capital investments for private venture capital (VC) entities. Jay has been spending the last few years poking around in the long-term-care industry, trying to learn as much as he possibly can to understand long-term care from a business perspective. From a venture capitalist point of view, what is attractive about long-term care, and how can we look at that differently than actuaries might?

Steve Mannik is senior vice president and general manager of the reinsurance division of Manulife Financial. Manulife is new to long-term care in a couple of ways. First of all, Manulife had very little or no long-term-care experience before a couple of years ago. Then, through some smaller acquisitions, Manulife became associated with long-term care, but only in a very small way. Then by investigating the long-term-care world and doing research on it, Manulife became more intimately involved. As many of you may know, Manulife and Hancock—Hancock being basically the number-two player in long-term care—have announced plans to merge, and so suddenly Manulife is very much in the long-term-care business. Steve will share some of his insights with you today.

I'm chief financial officer (CFO) and chief actuary of Avon Long-Term Care Leaders, which is actually a division of Manulife. It sounds like we're pushing Manulife, but we're not. The lead time for setting up speakers and topics is so long that this was set up well before I knew Steve in many ways, and so it's just an accident of history that we became involved together later on.

We're going to focus on long-term care. That's obvious. We're going to talk about risk as we have seen it in the past, risk as we may look at it today and risk as it might apply to the future. We're going to take some guesses about what kinds of things could happen to long-term care in the future and the kinds of things we need to watch out for and try to handle now.

My view of the long-term-care world is that there are risks that we recognize, and there are risks that we have trouble recognizing. Sometimes we call them embedded risks, or embedded derivatives, which is a bit of a new way of looking at the world for many actuaries. However, long-term care, as you know, is a complicated product, and any complicated product handled simply really means that you're just ignoring some risks that actually exist. Later on, I'm going to focus on some of those unrecognized risks and who bears them, because that is as important to our future as an industry.

We are not here to dwell on past mistakes as we see them—the old interest rate risk, the old lapse risk, etc. Many of those things I feel are more settled than unsettled at this point, and so we're not going to go into those. You know what they are. However, we do have almost 20 years of long-term-care learning. What have we learned in 20 years? I think it's a lot. We're not a new business anymore. We're not this nascent industry. We're a mainstream industry that continues to grow at a rate that far exceeds some of the other insurance products that we know and love.

We do know a lot, and there are some things we don't know. We'll talk about those, once again taking a step back and looking at long-term care in a historical perspective. It's not just an insurance perspective; it's a wider view. It's a look at insurance, and particularly long-term-care insurance, as a business, as opposed to our little world of looking at assumptions for pricing the next product. Let's think about long-term care in a wider view. That's how we'd like to try to go through this today.

MR. LARRY RUBIN: I assume most of you attending this session are in the long-term-care business. I'd like to start with a brief survey. How many of you would say you've experienced morbidity significantly worse than you expected when you originally entered the business? For how many of you do your financial results equal or exceed your original expectations? This brief survey confirms something I'm seeing when I look at many appraisals for acquisitions of long-term-care business, whether I'm advising the seller or the buyer. Very few companies earn enough to meet their hurdle rate in long-term care, yet surprisingly, the reason is generally not morbidity. For some reason, we seem to have gotten that right.

I want to start by talking about a typical long-term-care policy that probably was priced in the late 1980s or early 1990s. We all, most likely, have seen this. Morbidity was 70 percent of the SOA Valuation Task Force, interest rate was 7 percent, expense ratio was 65 percent, lapse rates were around 5 percent—that may be a little low with what was priced at that time—and mortality was 1983 Group Annuity Mortality (GAM). In fact, you probably originally went to management and suggested morbidity at 100 percent of the SOA Table, but you got a lot of pressure from marketing to be a little more competitive. For the most part, however, you felt pretty good about this pricing. After all, interest rates were at 9 percent in the market. Lapse rates on your life insurance products were in the double digits. You even used a conservative annuity mortality table. I want to take a look at what happened to this product we priced in 1990, take it up to today, and look at where this product is going in the future.

The first challenge we had was with lapse rates. I think we were all surprised that people who bought this coverage actually wanted it. Since long-term care doesn't have a nonforfeiture benefit, the reserve is forfeited to the company upon lapse. If lapses are lower than expected, the amount forfeited is lower than expected, and, therefore, premiums need to be higher. In this example, if we lower our lapse rate from 5 percent to 2 percent, we find that we under-priced our product by about 35 percent. I think many companies are actually even running lower than 2 percent.

The next challenge was expenses. State filing requirements have been anything but uniform in this product. In addition, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) imposed some unique expense burdens that were unexpected on the product. The rapid evolution of product features, frequent product regeneration and specialty expertise needed to effectively select risks were all significantly greater than expected. The higher expense burdens increased the critical mass needed to break even. This led, at one point earlier in this decade, to consolidations to try and get to the critical mass needed to deal with these expense problems.

Long-term care has had significant problems in the past. We continue to foresee problems, as well as opportunities, going forward. There are certain areas where we advise clients to be careful. The first problem we see is in mortality. I still see most long-term-care appraisals using the 1983 GAM as the underlying mortality basis. Mortality for long-term care has the same impact as lapses. The greater the level of mortality, the greater the level of reserves that are released and, therefore, the lower the pricing to the policyholder. I know we have two problems with the 1983 GAM. The first is that it's a 25-year-old mortality standard. The experience underlying that was from around 1975 to 1980. There's been significant mortality improvement over 25 years. We took a look at the ratio of mortality between the 1990-1995 SOA Ultimate Table and the 1975-1980 SOA Ultimate Table. Annual improvement rates are between 1 percent and 1.5 percent a year.

The second issue of the 1983 GAM is that it's a group annuity mortality table. Generally an applicant for long-term-care insurance passes a vigorous underwriting process to be issued. While the underwriting is not looking for things that are similar to a life insurance applicant, the applicant still needs to prove a significant level of health before he or she is issued. From our view, the mortality experience would be more akin to an individually underwritten pool than it would to a group annuity pool. We looked at different ages at some ratios of the 1983 GM to the Annuity 2000. If we were to change our price based on the 1983 GAM, we see that our product was under-priced by another 14 percent.

The other area in which we see problems is the investment earnings rate, which people are familiar with. While investment yields over the short term fluctuate widely, investment yields over the long term cannot be divorced from the real economy. In fact, long-term, real, risk-free yield should roughly equal real growth rates. We looked at the difference between two different investment returns in long-term care, the difference between a 7 percent reinvestment rate and a 5.5 percent reinvestment rate over 25 years. In the 1970s, real gross domestic product

(GDP) growth was 3.2 percent. In the 1980s, real GDP growth was 3.2 percent. In the 1990s, real GDP growth was 3.2 percent.

While real GDP growth has been fairly consistent, inflation has steadily declined over the past 30 years. In fact, we can get an idea of what market expectations are for inflation by looking at the difference between the 10-year Treasuries and 10-year Treasury inflation-indexed securities (TIIS). As of last month, this difference was 1 percent. By looking at this difference, we can see that the market expects inflation to average 1 percent over the coming decade. Our view at Bear Stearns is that the market expectations are too low. We expect inflation would be more in the 2 and 2.5 percent range, but still low by the standards of the last 30 years..

If we add the two together, we get our baseline economic outlook over the next decade of 10-year Treasury yields averaging 5 percent to 5.5 percent and returns on a balanced portfolio of 5.5 percent to 6 percent. Contrast this to the pricing rate of 7 percent built into many long-term-care products and to the 8 percent to 9 percent built into many pension plans. In fact, we can see historically where rates have gone from 1955 to 2000, and we see a return to a number that we actually have experienced in the past.

We can reach a similar assumption by looking at implied forwards in the London InterBank Offered Rate (LIBOR) swap curve. Let's understand what a forward rate is. Compare two investors. Investor 1 buys a two-year instrument yielding x percent. His accumulation at the end of year two is simply $(1+x)^2$. Look at another investor. He buys a one-year instrument yielding y percent, and he expects to reinvest at the end of year at z percent. The one-year rate one year forward is the value of z such that the accumulation for Investor 1 and Investor 2 would be equal. Long-term forward rates are peaking now at approximately 6.25 percent.

Forward rates have an excellent track record of overstating where rates are headed. In fact, we looked at a graph that shows the difference over the interval May 1, 1998 to May 1, 2003 between five- and 10-year swap rates as predicted by the five-year forward market five years earlier, versus the actual rate. In all periods, except for one or two months around May 2000, forward rates have significantly overstated where rates are headed. In fact, you could take this graph back 30 years and you would see the same pattern. So, if we go back to our policy priced in 1990 and make all of our adjustments, we find that we underpriced our product by 44.5 percent. Because of the optionality granted policyholders by insurance companies, our belief is that there's an economic incentive for companies to push the envelope on assumptions. The ability to file for a rate increase incents companies to be aggressive in assumption-setting in order to gain market share. We believe this is the pattern we've seen.

If a company is conservative, it loses market share on what could be a potentially profitable product. If a company is moderate, and the assumptions still turn out to be wrong on the low side, the company loses share on a profitable product. If the company is aggressive, and its assumptions turn out to be wrong, the policyholders bear the price with the rate increase. In fact, companies do better on their products if they misprice, raise rates and get policyholders to lapse. Unfortunately, this leads to negative press and potentially to problems with the insurance industry.

The other thing we see in looking at the options in long-term care is very often a one-sided interest rate. We've seen companies seek to exploit this. Even though companies can hedge their forward interest rate, you can always buy today's instruments that will guarantee that you can invest at the forward interest rates. In 1990, when market rates were 9 percent, and forward rates were 11 percent and 12 percent, you could have gone out 30 years and guaranteed yourself the ability to get 11 percent and 12 percent. However, if you do that, you also guarantee that you will not benefit if rates rise. For many companies, this incentive would lead them to the conclusion that if they lock in, they don't get the benefits of rates rising. However, if they fall, they can always get the rate increase. They're better off not locking, trying to ride it out and hope to gain from the rate rise.

In conclusion, in looking at the long-term-care market, actuaries can profitably price and manage long-term-care risk. Very few companies have lost money due to morbidity, which was the major risk when people entered the market in the 1990s. Economic forces have resulted in incentives to underprice products and leave risks exposed. We think that the regulatory structure has been insufficient to overcome these market forces. In fact, companies doing this are in essence acting in their best interests and responding to market forces. The natural trend is to take advantage of options you're granted. To really make this industry grow, we need more of a regulatory structure that works *with* market forces, that doesn't put companies into a situation where there's a fight for market share based on pricing that can be raised, but that truly allows the market to achieve its full potential on a clear, transparent pricing basis.

MR. JAY NEWMAN: I'm not an actuary; I'm a chartered financial analyst. I get close to numbers but I'm not as deep into it as you are, particularly with regard to pricing any given product. What I do for a living entails my developing and then partnering with larger institutionally funded private equity firms, not, in general, venture capital firms. The difference centers on our interest, not unlike that of other business investors and growers, in investing in established businesses with good managers and existing markets. We tend not to do things on a startup basis or on the back of an envelope. We're also very analytical, but we like things like cash flow. We also believe in things like capital structure and in building value.

Larry talked a little about the demand behind our little industry. With returns where they are, there's a huge demand and a huge opening for institutional portfolios—whether it's pension, endowment, insurance or large family—to consider their allocations to what's called "alternative" investments. Private equity is known as having held out historically a higher return for the risk, but also with some risk and with some illiquidity, so it's obviously not for everybody. It is for the larger, more sophisticated investor and has been proven to meet well under ERISA standards of the appropriate fiduciary and "prudent man" rules. The private equity industry is a large industry. There's probably about a $100 billion or so on the sidelines that's seeking to get out the doors over the next four to five years because there are certain time fuses on getting the money out in order to avail yourself of the capital that's been committed to your firm by larger institutional investors.

When Mark asked me to talk, he said that I should just give my perspectives. I'm not sure about historical or risk perspectives, but I certainly can talk about how we see this as an investment and also about the challenges that it holds out. When I refer to "eagles among us," whom am I talking about? First, I'm referring to private equity investors. By that I mean largely funds, typically cottage shops, each with five to 10 professionals. On the outside, you might see 20 to 25 professionals, or in some huge cases they go multiples above that, but in general in my industry, professionals number just a few people per shop but with lots of capital behind them available to commit on a discretionary basis, generally with a two-week call.

I'm also referring to corporate investors. When I say corporate investors, I'm referring to those investors who have corporate development arms who continue to look for ways to build and grow value, typically in ways that add to them in different ways. In addition, you have entrepreneurial investors. In your industry or in insurance industries, I would probably say that AIG, among others, would be an entrepreneurial investor. It's not your typical corporate investor. On the other hand you might take into account the fact that —we were talking before about some top-performing insurance companies—Northwest Mutual as a very smart entrepreneurial, value-oriented corporate investor. Not all have those characteristics.

What do we look for? By "we" I mean all of us. Although our capital can be a little different, we tend to do a number of things the same way. First, we realize that a lot of the value depends on the quality of the manager . We don't look for one-time transactions like a hedge fund investor would, who might see a good trade or a transaction where he or she could strip away some cash flow. We're interested in building businesses, growing businesses, adding to their industries and in the process adding value. So much of that is a function of the quality of the manager, including the manager's personality, perspective and skill sets. Second, as part of that, we look for businesses that come with a manager. I've been very privileged over this project in particular to work with a top manager within the long-term-care insurance industry. I've almost worn out the patience of others with whom I've worked in asking questions about this industry for the last two to three years.

I can't talk as technically and as specifically as I'd like to, but, again, we look at managers with businesses that we can get our arms around for sale or in need of capitalization. We have an ongoing interest as well in investing in companies where existing owners maintain a stake—it could be 20 percent, or it could be 60 percent—but we're partnering investors as well. We simply don't need to show up with a checkbook and hand somebody cash. The idea of a recapitalization versus an outright sale or management buyout is not something on which everybody focuses.

Another important part of this mix is that we need a company and an industry investment thesis. Someone might have a company for sale, and they probably have a superficial, very rarely in-depth, memorandum on the company. We step back and look at it within its market, within its industry perspective and within its industry. We look at the upsides, downsides and at where we can be in two or three years. It's not like a one-shot, cash-flow-stripping transaction.

I've had some thoughts as I've gone about the private equity industry talking about what I've been doing and being with people who have had formalized partnerships with me (because I develop, and then we have capital to co-invest alongside, and that's quite meaningful). The first thing is, "Gee, this is a great product. Everybody is buying it. Great demographics." Then you hear them say, "Yes, but this product is a sham. It's for sale, but no one is going to deliver on it. In the process, I have to commit $2,000 to$3,000 a year." This is the actual quote, not inspired by me. I just ask.

Then you do due diligence in the industry, and you see top brokers saying, "They've got all these systems, and they can't even talk to each other." One carrier had about seven different kinds of information systems, they still couldn't talk, and they were all sending out different statements to the same broker to try to work through. I refer to that as "legacies of legacies." Then another person in marketing and distribution, says, "I've got a great book. By the way, BISYS, and my book is $45 million." Twelve weeks later we're in his office. We're verifying this and corroborating that. It turns out we couldn't find more than $30 million. This is a person who had been in the business 10 or 15 years and was regarded as a pillar in a bunch of circles.

For someone else, we sketch in a letter, and our earnings before interest, taxes, depreciation and amortization (EBITDA) is, priced off of $3.5 million. We do like to see at least $2or $3 million, but my investment partners are able to invest between around $5 million and around $250 million of equity per situation. That's apart from any leverage that we may take on to shape out a capital structure. But if it's a growth industry, and he's quality, yes we'll be interested. We couldn't find more than $1.2 million (versus the $3.5 million).

I recently had a chance to talk to somebody who has terrific metrics. The productivity of the sales force is probably two to three times what you might see in different areas of this one particular kind of long-term-care insurance, and it's consistent. I've actually had occasion to refer to it as the "Bear Stearns" sales force in this little niche. I say, "That sounds really interesting. Tell me about what you do in the area of financial reporting and accounting. Do you have financial statements?" They do. I ask if they work with an accountant. Again, they do. I ask, "What are they? Are they compiled? Are they reviewed?" They say that they're not audited and not sure of the differences between 'compiled' and 'reviewed.' They tell me that they also do work with an accountant and do financial statements by Quicken.

Then you hear about BISYS. I hear people say they don't need anybody to come into this channel because they already have BISYS." At some point, whatever BISYS is doing in this little niche of long-term-care insurance is going to get the attention of BISYS' board. But they just bought another one for seven or eight times. Then another private equity shop—an arm of a very large financial services company—would say to me, "You know, BISYS is a great company, particularly if you want to sell a company to them. They're terrific. Whether it was long-term-care insurance or other areas, they were consistently 50 percent to 75 percent above the market. They're terrific."

In this industry, they've been paying six, seven or eight times, depending upon the year or the vintage, what are called "operating profits" or "earnings before taxes and amortization" (EBITDAs). At least, that's according to the numbers we worked through. Then there's the old song, "Where have all the brokers gone?" I know of one situation where they did that and this year their new volume is probably off 20 percent or maybe 30 percent. It's one thing to continue buying this way, but if the results aren't there, sometime it has to catch up. I'm not sure that they're the best leader for this market, but certainly they have to do something in order to be healthier for this market.

The point is that if we're interested in buying, we're almost partnering and entering a marriage in this industry. This is the flak that I've had to run up against in carving out our efforts here. I'm pleased, even with that, to have been able to come to the table with very significant capital pools, who at any given time would have been able to write a check for 50, 100, 200, or, for that matter, 27.5 or 30. Capital is not in scarce supply. It's a matter of the economics of the deal and the value that we can actually bring to it.

With regard to long-term-care insurance, insurers certainly have their challenges. This morning I stopped by a seminar on cutting-edge areas in reinsurance. In the long-term-care insurance area, someone commented that he saw this as an adolescent product market. We couldn't agree more. What are the telltale signs of adolescent product markets? You see people enter. You see people leave. People are still in some flux. That's what we see in this market. It's interesting. We would tier it, obviously, "active new" and "closed." But what this person said was that he saw the industry consolidating. Huh? If this isn't consolidated, I don't know what would be. You see new issues concentrated at 80 percent plus in the top seven or eight. However, he evidently thought that it was going to be even more of a shakeout. Then you have to separate them between stand-alone and diversified and where they are in terms of product mix.

Challenges facing long-term-care insurers include pricing and underwriting, market share, marketing efficiencies, first year/renewal terms, policyholder services, claims administration, capital management, and financial and accounting systems. – With regard to marketing strategies, the tendency of many carriers to follow a vertical push may not have helped the strength and the health of the overall channel. With regard to financial and accounting systems, I stopped by another seminar about developments on the Accord system and the Accord standards. That holds out some very interesting hopes for being able to put data on an import/export standard that could actually talk to each other. That would very much ease everybody's pain, whether you're among the carriers or whether you're in the channel. I'd very much encourage you at your carriers to consider adopting and implementing the Accord standards as quickly as possible because in financial and accounting systems, from what I've seen, very few people are able to really put their arms around profitability.

It's one thing to say, "We price a product this way," or "The market is here. We price it here." We take it beyond there. Then we look at business. After we do all that, we juxtapose that to industry. We have to add all those things together to see where it's going to make sense, and obviously this has to come down to profitability. Profitability. Growth. What can we get for our investment?

In long-term-care insurance we're hampered from investing in you in a couple of ways. One is, we obviously can't leverage you, not to say we want to aggressively leverage every company we see. We like conservative capital ratios, but we can hardly even put much in the way of leverage on any insurance company, let alone long-term-care insurance. So we have to find other ways to make our returns. For us to invest in a long-term-care insurance business, we need to see business with profitability. We haven't really seen that as yet. What we have tried to do, in the absence of that, is look at areas of marketing and brokerage services.

I should say that this market obviously segments. One smart private equity group discouraged me by saying, "Jay, they're all crooks. Don't bother." I'd say what I've learned, maybe through the professionalization of this industry, is that there is a segmentation. There is quality. There's low quality. That's not just in the channel. That's in other people, other kinds of market participants, and in the ways that they approach this business. There's integrity, and there's not. That's not just integrity in what you say you're going to do. It's how you approach a business, whether you're really going to try to grow it or whether you're going to try and strip it.

In terms of its challenges, the challenges to an investor who's going to try to invest in this business are absolutely daunting. The entire channel is governed by a cottage shop and a small-business mentality. It's not healthy. What do I mean by that? "You don't need another channel participant, and you have BISYS." BISYS accounts for probably about $30 million of new premiums out of about $1 billion that's going to be sold this year. People say that it's a slow-growing market. In certain metrics the market is obviously faster growing, and in areas of asset management, I look at the numbers that accumulate based on the year before. But it's a small-business mentality. People almost go into this business for the renewals. If you want to buy them, they say that they'll strip the renewals out, and then you can put in cash alongside.

In any other business that has recurring cash flows, you don't hear people say they're going to try to strip out their business. In this business, you are able to do a lot of that because the way the channel has been developed, the marketing and brokerage services aren't asked to take on a great deal of post-sale policyholder sales and service support. It's a little unique that way. With the way you have your contract terms so that it's vestable and assignable, it allows for that, whether that's healthy or whether that's not. However, it's a small-business mentality. If you have that mentality, you're not going to grow. You're not going to invest in systems. This market has no channel leader right now. It has one main carrier who has got a multi-channel focus who accounts for, through its networks, about 30 percent of new issues. Apart from that, it drops radically.

In the channel you have everybody vertical push, with carriers extending money to them so they can't get weaned off of it. When they talk about their best product, they talk about the two or three that they have terms with and where they're incentivized. That compares with sitting down with a top-rate financial advisor and you were going to research, say at Bear Stearns, a municipal bond portfolio. You have access to all of them. You know their terms. You're able to put together the best selection, and then you're able to say which are the best ones for the client and for you to consider. This market doesn't allow that, and it's not going to allow investing in this as long as people are governed by, "Okay, these are my renewals, and if you want to buy me, then you have to strip them out because they're my retirement savings."

I'd suggest that in this channel there are ways to consider things, whether it's estate freezes or other kinds of long-term payout mechanisms. Renewals, after all, primarily have a 10-year horizon or so. There are ways of investing, buying and recapitalizing businesses so that the cash flow doesn't have to be stripped out. If the cash flow is not stripped out, then you almost have the makings of a capital structure. Then you can build. You can buy. You can invest. You can do a lot of things. As this is extremely fragmented, there is no reporting. Everything is still green eyeshade. There's no capital market access. If someone is in the channel and they want to get out, all they can do is sell.

When Mark asked what my topic should be, I should have summarized it as "anguish and frustration." There are parts of this channel and parts of this industry that I haven't seen. There are probably great businesses and great managers that we haven't seen, and we'd like to meet them. So, when people say where the money is, maybe it is in a large part in marketing and brokerage services. There's probably $500 million to $600 million sloshing around in renewal cash flows not requiring post-sale services support. There should be someone here who accounts for at least 5 percent to 10 percent of new issues and who holds out real value to the financial advisor, almost a mega broker, if you will, or the Marsh & McLennan in this niche. That's the opportunity that we see, and we're looking for the manager and the unit that we can build from.

What did we see this last year? We saw all the earmarks of an adolescent or getting-on-in-years-a-little-bit adolescent market. We see increased rates, tightened underwriting, carrier withdrawals and carrier combinations. What's interesting, though, is with the federal government employees. They're showing that other ways of channel marketing do work. However, they require the time, effort, professional management and resources that you don't see currently in the channel.

I've had a little experience with Long Term Preferred Care (LTPC) and ACSIA . It's unfortunate. In each of those two cases, they clearly had a book of business, although one was higher quality than the other. They had market positions that had been built up. You could say that one was more profitable, or profitable, and one wasn't. On the other hand, there was probably a misallocation and a gross misallocation of resources in one versus another. The fact of the matter is that with each of them, and we were close to each of them, the managements—or under their mandates—were looking for the silver bullet to feed their existing channel marketing strategy. They were stripped out or sold prematurely. They already were on the verge of having been able to grasp the brass ring, whether that was for Conseco or somebody else, and that next person or their own parent isn't going to see it. That's hurt this industry.

We haven't heard much talk about this year, maybe because you've been through political changes so many times. I think we're going to see through Howard Dean, and everybody else, a lot more focus on long-term care as insurance or in terms of the availability and quality of the caregiver. How much should the caregiver be paid? In the state of Florida, for example, should you continue to encourage people to work with registries or should you consider a more employee-based system for the caregivers that you work with? Expect to see continuing market development. Often when someone shows me a business, I ask: Who are your competitors? In this I'd suggest that it's not just conventional long-term-care insurance. You see many other people or marketers entering with the kind of tangible benefits that in many cases I think will outcompete against conventional long-term-care product structures. See renewals continue to slosh around. I think they're going to. Often they'll be siphoned away. Most importantly, I see room for continued channel leadership.

Let's talk about the "show me's". As an industry I'd ask you, since you're in adolescence, show performance to the capital markets. That means profitability, cash flow growth and real numbers. Show me the good managers to build these organizations, not just to do a trade. Show me businesses and business units for sale or investment. If there are carriers who have or are served right now by captive or proprietary distribution channels that are being under-utilized, we might have a thought or two on how to grow them with you.

MR. STEVEN MANNIK: Manulife, through the reinsurance division, entered the long-term-care market in March 2003. When we put out our announcement, I had two separate reactions from two different groups of people. If I was dealing with a long-term-care person, he or she would say, "The industry has had its challenges. Some companies are leaving the industry. You're a genius for getting in at this stage." If I was talking to someone not in the long-term-care industry, he or she would say, "The industry has had some challenges. Companies are exiting the market. You're an idiot for getting in at this stage." Today I'll give you our rationale for entering the long-term-care market, and you can decide for yourself.

I thought I'd start out by giving a little bit of background on Manulife and the role of the reinsurance division, which I head up, within the company. We have divisions in the United States, Canada, Asia and Japan that are direct operations selling a combination of individual insurance, wealth management, some group products, and life and health. We're only selling health business in Canada and Asia; we don't play in the health marketplace at all in the United States. In the reinsurance division, we have three main lines of business now, which are life, property and casualty (P&C), and long-term care. We account for about 13 percent of the bottom line of the overall company.

Drilling down into the reinsurance operations, our bread-and-butter business in our life area is life retrocession. We've been in that for over 20 years, and that's our biggest business. We also do structured reinsurance or financial reinsurance for life and annuity products, and we have an accident reinsurance area. On the property and casualty side, we are a property catastrophe retrocessionaire, and we also do some aviation catastrophe retrocession, both on traditional and nontraditional bases. With our newest product line, long-term care, we're coming in and operating very differently. In these other areas we're typically a retrocessionaire, and we're providing a commodity product. With the long-term care we're coming in as a product-support provider, offering turn-key operations and also providing the long-term-care reinsurance that clients would need.

Why is the long-term-care insurance market attractive at this stage? Obviously there has been some top-line growth in the industry, but it's still pretty low in penetration if you compare it to other insurance products. Certainly the demographic trends indicate increasing demand for the product going forward, and there's obviously government support for private long-term-care insurance. Clearly the government cannot afford to be supporting long-term care in the public way. Certainly we expect growth beyond the individual into the employer and group side of the businesses. As far as the profitability issue, there have been some issues with the product, but we see a maturing in terms of pricing, risk management techniques and some of the benefit features that are now typical in the products.

I thought I'd give a little history of the marketplace from a pricing perspective. This is how I viewed it as we were looking at entering the marketplace. There have certainly been a number of areas of inadequate pricing, and obviously with a very long-term business there have been some difficulties getting credible data. One of the biggest areas of concern was around the ultimate lapse rates, and that has been discussed by the previous speakers. As far as investment returns, the product was priced in a higher investment return environment, and now you're not earning those returns. So there are concerns there. Some pricing tactics were designed more for market share than for profitability. We've also seen some product design, underwriting and claims management areas that could be tightened up and that needed to be tightened up.

Going forward, we think that there's now better data than ever on the lapses and morbidity. With the NAIC model regulation saying that you have to price and certify that your product pricing can hold up under moderately adverse conditions, that should lead to more rate stability. With regard to general recognition in the marketplace, we feel that to be successful you need to have expertise in the areas of product design, underwriting and claims.

Why did we choose to enter the long-term-care insurance market? First, we were faced with a unique opportunity to acquire some expertise. We had a group of people that had been displaced as a result of a divestiture, and so we had a time-limited ability to pick up some expertise. Certainly I was not willing to go into a very complicated and niche market like this without getting expertise. That was key for us, as was the ability to leverage those resources amongst a number of clients, and within the reinsurance area we can do that. As we looked at it and looked at where the pricing is today, we felt that there would be attractive financial returns going forward for the business that we could write. We've been able to set up our operations through a relatively small shop, and being a reinsurer means that we can do it with a small number of people.

We've got small start-up costs and low ongoing costs, which means we can be disciplined about the business we write. We don't have to write large volumes to justify the expenses that we have on a fixed basis. I think you're seeing more and more that this product, being a very long-term product, requires strong capital and good financial ratings to be successful, and we think we've got both of those. One of the very important elements that maybe was unique for us was that we didn't have any long-term care elsewhere within Manulife, and the diversification elements that that gave us with our other businesses was an important factor in going forward with this.

Using a pretty crude rating system, I'd like to give you some idea of how we viewed long-term care within the context of the reinsurance division at Manulife. We've got each of our three lines of business, which are life, P&C and long-term care. If we look at the major product risks we're taking (investment return, mortality, morbidity, lapse and catastrophe) and rank them zero to three, we see that one of the reasons we like property and casualty is that it's got very different risks and not correlating risks to our life business. When we look at long-term care, a lot of the risks are, again, not correlated. In fact, in the case of mortality and mortality improvements, there's actually some natural hedging built in there between that and our life business.

We put together this group called Avon Long Term Care Leaders. It's providing a wide range of services. We didn't go in just as a risk provider; we felt it was important to be a full-service provider. We offer program creation, marketing support, underwriting claims, reinsurance support and also administration. We felt offering administration was important if we were going to support clients who were new to the business. We didn't want to set up the administration ourselves with a large infrastructure, a large shop, so we were able to partner with a third-party administrator on that to keep our start-up costs down.

We're looking at a wide range of potential areas to do business. We're looking at working with existing long-term-care insurers, with new companies that are looking to enter the marketplace and with companies that are exiting the market, where they need a home for the obligation and the runoff of existing blocks. This is the value proposition we think we put forward, and we think it will play well in the marketplace.

Finally, this is our view, our summary, of why we got into the business. We think the demographics are favorable. Being a niche market works for us. There's relatively low penetration, so that leads to high growth rates. We're a global marketplace. We have operations around the world, and we think we can leverage that. We think all that, plus the maturing knowledge in the industry and the improved pricing that we see going forward, will lead to a profitable future for us in the industry.

MR. NEWTON: You've heard a number of things today, many of which you already know. Maybe there are some things that you took away from today because our panelists are a little unique and have somewhat of an outside view of the long-term-care industry and the insurance industry in general, and maybe some of that was able to resonate with you. Because our panelists are so different today—we chose them specifically that way to take a completely different view of the world—I want to try to go over some of the things they talked about in different presentations and add a few remarks of my own.

Under general philosophy, "We do not inherit the land from our ancestors. We are borrowing from our children". What does that mean? That means that for all of us in this room, we're passing through long-term care. Are we not? We have a finite length to our careers, and yet what we do today and how we set ourselves up for the future of long-term care is going to matter in the future. Long-term care, whether it's insurance or not, is going to have a long history. People get sick and have problems before they die. You and I are not going to stop that. What we're trying to do is maybe, coarsely put, capitalize on it, but what matters is how we set up our industry for future growth and to make sure that the future growth is there.

We're coming up on 20 years of being in the business of long-term care. I think of long-term care in terms of around the mid-1980s, 1985, 1986 or somewhere in there. There were a few carriers who dabbled in long-term-care-like coverages a few years before that. But 20 years is long enough to learn something. I'm not going to go through these ad infinitum because you've already seen them today. I'll just go through the categories. We can understand the risk that we're taking on better, and we can choose it better than we used to. That is absolutely true. We have better claim adjudication than we used to in the early and old days. As far as the market goes, I think the demographics are still compelling. Other carriers agree. The penetration is low.

Governmental support is something that varies around the world. Most people tend to view long-term care in terms of what's happening in the United States, but I assure you that there are many, many countries around the world that are grappling with the long-term-care problem as we are. There are many countries around the world that are 10 or 15 years ahead of the problem from where we are, in the sense that their problem will hit them squarely in the jaw 10 or 15 years before it will hit us.

In pricing, there were early mistakes. I consider "mistakes" a poorly chosen word. In any industry, especially insurance that's a brand new line and has no history, to say you've made a mistake is probably true, but if you don't know anything more, then you do the best you can, and we did the best we could. Sometimes we were right, and sometimes we were wrong, but the point is that we learned from what we did early, and we've improved greatly.

What are the areas that still need work? Let's look forward a little and try to understand that. I think everyone would agree that while we have a fair handle on what things are like in your 50s, your 60s, your 70s and maybe even into your 80s, I don't know that we have such a good handle on what happens to people in their 90s or in their 100s. There's going to be many more of those people in the future than there are now, and we have a relatively poor ability to assess that risk at this point in time just because we don't have any experience with it. There are societal trends that are going on. Entitlement is something that all Americans are used to. If you're not used to it personally, you're hearing about it everywhere.

The effect of technology will probably, in my opinion, have a huge impact on what happens in the long-term-care industry. The Baby Boomers are a massive group of people moving through the political system, and they're moving through the waves of technologies. If you heard the speaker on Monday talk about genomics, you can begin to understand, or at least recognize, that somewhere in the not-too-distant future, life is going to be very different for some of us who are lucky to benefit from that. It will be different because of technological advances, some of which are happening today, especially in the area of dementia.

There will be regulatory changes. Some of them we will like, and some of them we will definitely not like. But my personal opinion is that if we can't get our act together in certain ways and correct some of the problems, mistakes or missed opportunities that we are faced with right now, then regulation is not going to be our friend in the future. It's going to be another obstacle to deal with, and we need to think about that in all the things we do. We tend to think about regulation in terms of regulators, but, in fact, in the United States in particular compared with many other countries around the world, there are formal regulatory mechanisms, and there are informal regulatory mechanisms. The informal one that you've probably heard about the most is also called the American Bar Association. If we do not get our act together in terms of some of the sales process and in terms of the value proposition that we offer to consumers, then the political regulatory system and the informal regulatory system will not work in our favor.

I also think that we need to look at some fundamental design issues. I read a fascinating article recently—I believe it was not in the United States—talking about the pension systems in the United States and Canada. The first line of the article was, "Pensions are in the news, and the news is not good." The article was written by Keith Ambachtsheer. His message was that providers of pensions are saying that asset shortfalls are temporary, but in the long run everything will be okay. That's not very much of an assurance to me, and I would say that factually the trend is opposite. Defined benefit plans are on their way out, not on their way in. You can liken some of the problems that pension providers have been through lately to some of the problems that long-term-care insurers face. If long-term care doesn't want to go the way of the defined benefit plan, then I think we need to truly look at some of the risks that we face.

We face risks that are obvious and that we know about, and we face embedded risks that are not well understood. They're not well understood because they are not clearly stated, and it's not clear to some of the people who buy long-term care who is bearing those risks. The perception is, at least among the buyers of long-term care who are our customers and who actually pay our bills, that the insurance company bears the risk. That's what they pay for. When you buy an insurance product, you're paying a small premium to transfer the risk to somebody else. Consumers view long-term care just like any other insurance product, where the risk is on the insurance company.

In my personal opinion, that is not exactly the case. In the ideal world companies bear the risk, and if everything goes well enough, companies do. They take your premiums. They add them up with everybody else. They pay claims when they should. Life goes on as it should. If we look at the history of long-term care, I would argue, factually based again, that some companies take the risks, but policyholders bear much more risk than they realize when they buy long-term care.

You don't have to look very far to look at the level of rate increase history in long-term care and the number of companies that have rate increased their policyholders to understand that policyholders who buy long-term care basically provide optionality to the insurance company, because insurance policies are guaranteed renewable. That is an embedded option that policyholders grant to the insurance company. Many insurance companies have not been very shy about taking them up on that optionality.

Do companies bear risk? Again, yes, they do. Companies actually backstop risk through the guarantee associations, and so the companies themselves are actually the final risk-bearers. Poor understanding of the embedded risks leads to low value. How is that? If you don't understand a problem, you can't solve it. Poor understanding of the risks and who bears them in long-term-care insurance leads to poor execution. Poor execution leads to low value. The execution is not helped in many instances. The accounting rules that we currently work with in the United States do not work in our favor in terms of identifying the risk, identifying who bears it and identifying how the risk could be managed or hedged. I think the governance of long-term care has been lacking in many instances—and I'll go through that—but poor execution leads to high costs, and it leads to low consumer value.

The accounting systems do two things. They mask fair value. That means if you're going into a company and you're looking at what the fair value of their book is, it's not at all obvious. You certainly can't look at statutory U.S. accounting rules and understand the value of an insurance block. I would argue that even in U.S. GAAP there are many things that are papered over or are incredibly inaccurate in terms of understanding the fair value of a block of insurance. Accounting systems can also obscure consequences of poor risk management. This is true of many other lines of business than long-term care, but in long-term care the fact is that risks are not identified very well, who bears them is hardly identified at all and most companies still in long-term care are not doing very much in terms of hedging the risk or even executing basic risk management. That is not true of absolutely everybody, but it is true of some, and sometimes the appearance of what happens with some affects what happens to all of us. We need to look at that a little more.

The key to governance is early market signals of trouble. The old statutory regulations that we have are not at all conducive to early warning or effective action. If you have early warning, you have a chance of taking effective action. If you have no early warning signals, you have no chance of acting early and making the problem better sooner. The new rules that we're talking about right now seem to point to a "one-size-fits-all" approach, despite the fact that the industry and the companies in the industry are hugely fragmented in so many ways, but particularly in terms of their ability to execute basic long-term-care risk management and transactions. The new rules also seem to add conservatism to reduce the need for future action. What do I mean by that? The new rules are basically updates on the old rules. Since the old rules don't point to ways for early action, the new rules say that one can reduce the size of one's future problem by putting everybody in one bucket and making the bucket much more conservative than it used to be. The focus really needs to be on ways to find out what's happening early. The statutory rules we have and are proposing don't, in my personal opinion, fill the bill there.

As far as the state of the industry, there are some companies exiting and there are opportunists entering. The good news is that information is available from a huge array of sources. If you don't have the information yourself, you can go to a wide variety of very competent providers and get whatever information you need. All the attributes of the industry that made it attractive in the first place are still here.

Should you be in the business or should you be out of the business? That's not the question. In my opinion the question is, *how* should I be in the business? Most insurance companies think about being in or out of the business in terms of "I have to do everything or I have to do nothing." Why is that? You can tranche this business. You can consider your particular skills, apply those particular skills and divest yourself, through a wide variety of mechanisms, of any of the other things you don't want. If you think the industry is attractive, be in, but be in the places where you have a strategic advantage and where your company performs particularly well relative to other companies. I think things are good. I look at the chaos that's in some of the industry today and say that that's where I want to be. "Buy at the sound of cannons, sell at the sound of trumpets." The industry is in chaos. Blood in the streets means opportunity, not problems.

For effective ideas, we need to expand our world view. See the forest, not the trees. One example is in the proposal for statutory changes on valuation. We're down to arguing whether lapses should count at year four or five and whether it should be 80 percent of lapses or 100 percent. That's a minor issue; that's a tree. We need to look at the forest. We need to try to understand early recognition of our problems and give regulators the ability to see when problems are happening much, much earlier, especially in long-term care where you can be in a lot of trouble early and never know it.

As far as the FASB proposal, I'm guessing that most of you, and I could be wrong, don't know that FASB is out there looking at a more global view of accounting. It's a multidisciplinary effort from many, many countries around the world asking, "What is the essence of accounting that we want to have on this planet?" It's not just the United States. It's not just Europe. It's not just Asia. How can I create an accounting system that really gets at fair value and provides early warning signals? They are already working on that, and that will be coming to a country near you in the near future.

We need to continue to define what we do. We're very good at that as actuaries, and we've spent the last 20 years in long-term care doing it, but we need to look at our focus. Many of us who have priced products in the past go with our best-estimate assumptions. There's one best estimate for interest. There's one best estimate for claims, for expenses and so on. What I've learned personally over the years is not whether I'm going to be right or wrong, because I know I'm going to be wrong. The question is, what do I do when I am wrong? We need to do a lot more stochastic testing about different kinds of scenarios so that we can understand the risks that we're taking on, and so we can apply mechanisms for managing those risks or divesting ourselves of them. We need to look at risk transfer mechanisms. That's part of the reason that I asked Larry to be on the panel. We can look at investment bankers. We can look at capital markets. We can look at reinsurers. We can look at outsourcing services. You can do all those things. They're there, they're available for all of us to take advantage of and there are tons of them. There are many companies that would be willing to do this. We just need to get out of the hole of assuming that we have to do everything ourselves. That's not it anymore. Let's use capital markets as an example. That's a place to manage risk, if you want to do it that way, or divest yourself of risk that you're taking on with long-term care.

Lastly, is it too risky to say that we need to enhance the value proposition for consumers? The regulators are certainly looking at it that way. I might be able to argue convincingly to some people that what we offer policyholders is good for what it does, but it leaves so many things open. It still leaves the policyholder with so many risks that the value proposition is in some instances quite small because we can always go back and work with a rate increase. In long-term care, by the time you get around to a rate increase you're not talking about three percent. You're not talking about five percent. You're talking about 20 percent, 30 percent, 50 percent or 100 percent rate increases. That's a lot of money to someone who's 75 or 80 years old, and that's not the way we need to set ourselves up. We need to try to find ways where the value proposition for the customer is better than it is right now. That's a challenge for us in the future.