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Session 6PD
Long-Term Care Reinsurance

Track: Reinsurance, Long-Term Care

Moderator: STEVEN J. PUMMER

Panelists: TIMOTHY EDWIN HALE
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Summary: Long-term care (LTC) insurance is a very new product. The emerging experience forces direct writers and reinsurers to constantly reassess assumptions, particularly persistency. This session covers how reinsurers and direct writers respond to emerging experience and work together to modify contract terms or take other actions to represent and protect each party's interest.

MR. STEVEN J. PUMMER: I'm with Tillinghast in St. Louis. Our first speaker is going to be Tim Hale. He is an assistant vice president and health actuary with Munich American Reassurance. He's been with Munich since 1998. Tim is running for the LTC Section Council, so he'd like to encourage you to vote and vote often.

Our second speaker is Andy Perkins. He's senior vice president with Gen Re Life & Health. He has more than 30 years of experience in the insurance industry in all facets of individual health, including 20 years at Travelers where he was responsible for designing and pricing a variety of individual health products. Now at Gen Re, he heads the individual health reinsurance division, which focuses on LTC, disability insurance (DI) and other supplemental health insurance products.
Tim's going to start off by talking to us about some general reinsurance terms and types of reinsurance with regard to LTC. Andy's going to talk about some other things, including roles in the reinsurance treaty and relationships, as well as reinsurance guarantees and allowances.

MR. TIMOTHY EDWIN HALE: As Steve mentioned, I'm going to be setting the table, and Andy will be serving you the meat. We're assuming a medium level of knowledge for people, so we hope you're familiar with a lot of the terms that we use.

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These are just a couple of the fun things that people tend to face as they sell LTC insurance for us, and I always liked Mickey Mantle's comment: If he knew he was going to live so long, he would have taken better care of himself. Let's look at some of the common terms. With the LTC product structure, most of us are familiar with the benefits and the premium structure. We typically pay for services being received, or you can work into an indemnity-type product—if you're disabled and eligible for benefits, full benefits would be paid regardless of the services you receive. Again, I'm assuming most of us are familiar with a lot of these things—incidence, continuance, interest, returns, return on equities (ROE), internal rate of return (IRR) and those sorts of things.

First I'm going to talk about benefit eligibility. I think we've all moved toward an activities of daily living (ADL) measure. It seems to be a good measure for benefit eligibility. Most of what I'm discussing applies to new business and is not applicable to inforce blocks and takeover blocks. So, keep that in mind as we move forward.

In theory, each one of the risks embedded in LTC could be reinsured separately. I say "in theory," because most reinsurers do not want to take one particular risk out of this. We typically would like to have sort of a global overall sharing of the risk. However, part of my discussion is that each of these elements could be reinsured separately. Typically, you could look at the incidence risk, and if more claims are experienced than what I expected, you could certainly design reinsurance coverage to take on excess claims. If it's more than pricing, the reinsurance might kick in at a certain point. Claim continuation risk is the longevity risk where a claimant might be slower in recovering. The reinsurance coverage might increase to cover claimants after a five-year benefit period.

Persistency risk has always been there. However, companies are tending to at least recognize that people are not voluntarily giving up these policies any longer. I've been seeing ultimate persistency rates dropping down to 0.5 percent. Hopefully we've started to recognize that in the pricing, and I think we have since prices have been going up lately. And, of course, interest risk is always there since this is a level-funded product, and we accumulate the premiums early on before we expect to pay out any of the benefits. How that money is managed, as well as invested, is obviously a key point for LTC pricing.

I'm going to mention again some of the traditional reinsurance methods. Coinsurance: This is where we tend to share all the risk together. Risks are shared across the board. We haven't selected just one, but we are taking care of all of them. This can be basically coinsurance on a quota share—a 50/50-split. We can look at an excess of time or a dollar amount. For example, if a claim exceeds $500,000, you might be able to find reinsurance coverage just for that risk specifically. Modified coinsurance: Typically this would be where the direct company holds the assets for the reinsurer, and they take on the investment risk and would possibly give a guaranteed return.

With yearly renewable term (YRT), this is just as in life insurance where often they focus on just the mortality risk. Reinsurance coverage can be structured so that the morbidity risk is what's being reinsured. The premiums to the reinsurer would be reflective of the slope of the claim cost curve. They start out very low in the initial years where the expectations are low, but then would—within five, 10 or 15 years—start exceeding the premiums being paid by the policyholder.

Then you can look at stop loss, and this could be on an aggregate basis if an entire block exceeds a certain expectation, or on an individual policy side as well. Typically we are not keen on doing pure aggregate stop loss unless it's part of a broader program of reinsurance. A lot of these are theoretical. Finding that coverage might be a little bit more difficult. I just wanted to note that both the incidence and the continuation risks are subject to fluctuation. Those are areas in which companies are looking to try to keep their risks small.

There are some nontraditional reinsurance methods. I'm seeing a lot more activity in substandard LTC risks as underwriting becomes more refined and risk assessment is getting better. We're seeing new tools to review and do the underwriting risks. There are some Internet computer-based dementia tests that are being developed and tested, and probably will be available. It's very important that the insurance industry be the leader on this because if it's not, then obviously the general public will begin using these tests and selecting against us.

Multi-life risks are usually group. We're seeing a lot of worksite products. The age of people buying this insurance is dropping—40s and 50s. A lot of companies are looking at the sharing of this risk, since we're basically selling policies where we don't expect to be paying benefits out for 20 or 25 years. Employer pay or employee pay could be voluntary. We're just seeing many different kinds of multi-life, guaranteed standard issue, guaranteed issue, modified guarantee issue, etc. From our point of view, the reinsurer would share this on a typical coinsurance basis so that all of the risks are somewhat shared.

Claims-only reinsurance: This could be something where the direct company would cede to the reinsurer after a certain point in time. It could be all claims that exceed a $500,000 threshold. It could be all claims that exceed a four-year period. This can be designed to what the company might be looking for. This allows the ceding company or the direct company to reduce the longevity risk or eliminate it. In our industry, with lifetime unlimited benefits, this can be a major concern.

Substandard impaired annuities: These are typically immediate annuities sold on a single premium to people who are already claim-eligible; several companies have been dabbling in this and are selling these products. Essentially, you would do an assessment of the condition of an individual; what services he or she is using. What is his or her health status? What kinds of services are being provided? Where is it being provided? What type of facility? What is his or her desire to stay alive? Typically aimed at dementia-type patients where a family has been already paying

for services over a number of years, and in order to preserve the estate or their own inheritance they may be willing to spend $100,000-200,000 to guarantee a payment stream across the rest of the insured person's life.

It usually is based on that comprehensive assessment, because you're doing basically a life expectancy guess. These are substandard lives. Is this going to be a 24-, 36- or 48-month life expectancy? Pricing would be based on that. There also are some reserving standards from 9(c) that relate to substandard annuities, and it wasn't until recently that you had to reserve for these people as if they were standard annuitant lives. You could not reflect the substandard nature of their conditions, but that has now changed.

We'll talk about some of the reinsurance needs. I'm speaking mostly from a reinsurer perspective because we don't have a direct company on our panel, but our goal is to be partners in this deal. So, our expectation is that we will share the risks of any of the unknown and adverse experiences. Reinsurance also can be used as part of the financing need; it helps reduce some of the surplus strain. Reinsurers can offer turnkey programs that can range from doing everything to bringing products to market, to doing very simple underwriting programs. Claims administration can be combined. They can be separated. Underwriting is another area where we're seeing more activity. Companies are looking for guidance and for some of the newer technologies. They are looking for help in putting their underwriting guidelines together and reflecting those in the pricing.

This all comes down to creating partnerships. We need to have shared expectations. Finding the common ground is not always the easiest thing to do. When we're looking at a possible client, we're going to look at all of this. We're going to look at the pricing. We go through the same exercise. We look at all the assumptions, competition, market and what they're willing to bear. The reinsurance allowances are what we fund back to the company to pay for the expenses, the compensation to agents, the administrative costs, the claim costs and things along that line.

Underwriting and risk selection: this is one that tends to cause more of a conflict between reinsurers and direct companies. Again, we are giving a direct company binding authority based on its underwriting standards and how we understand those underwriting standards. Underwriting is not an exact science; it is an art. People are being reviewed and have multiple conditions. They are not always healthy, so the expectation of how these individuals are being underwritten is key. We expect to pay qualified claims, but we also expect to review any claims protocols; understand how a direct company will pursue claims that might not be qualified. What are their expectations during a two-year period when I can contest a claim? So, again, our goal as the partnership is that we expect to pay qualified claims.

The next place where the most conflict can arise between a direct company and a reinsurer is in the contract language. The policy contract usually is the actual policy contract language. Those typically have more to do with state regulations and are less likely to cause the conflict. It's more in the reinsurance treaty, which is an agreement that is trying to encompass all of the possible things that can go right and can go wrong. It's very hard to try to get everything done, but we try to cover all the areas.

Our expectation is that you will follow the guidelines that were agreed to. There are always exceptions. There are always reasons why someone might issue a policy. We want to just be informed. We want you to document what is going on. What was the underwriting decision? Why was the policy issued? We're not there to police a company. We just want to be a partner and understand what exactly the thought process behind it is.

Extra contractual damages: This is an area that can cause conflict. It could be that the direct company, God forbid, is sued for some reason. They look at the reinsurance contract. It says, "I cede 50 percent of this risk." So, the reinsurer should be willing to pay 50 percent of any contractual damages. Our thought usually is if we're involved in the decision process that caused the lawsuit or the damages to be paid, yes, we would be willing and able to pay our fair share. If this is due to, say, agent fraud where we have no control over the agents and the distribution system, if this is not addressed in the actual contract language, conflicts may arise.

Reinsurance administration is another area that sort of helps. Typically the direct company does the reinsurance administration. So, as a reinsurer we're relying on the direct company to supply us with the data, the information, on an accounting basis so that we can verify that the premiums being paid to the reinsurer, less the claims and the allowance and expenses, are accurate. The other part, though, is we're also trying to track experience and how the business is performing. Typically we find that our expected basis will be different than the company's basis. This is a challenge to the overall industry. Since we don't have standard tables, we don't have the exact same basis. So, we're using morbidity assumptions that we developed.

A direct company might be using its own standard that it got from a consultant or some other source. This is an area that can cause conflict simply because we have different expectations. So, we want to be more informed. We want to be more involved. We don't want to be a parent and come in and tell people what they can and cannot do. We want to do our own homework up front, understand and agree with a direct company on what it is going to do.

Another one I didn't mention is recapture provisions. This is a tough one to spell out in a lot of detail. Certainly we can come up with explicit processes to follow, but quite often we like to leave them somewhat general, saying that we'll both agree on

recapture provisions. So, if something is completely spelled out, does that mean then that we cannot be a little more creative or reach an agreement outside of what a treaty says? A lot of companies don't like having something general said like that. So, again, this is another area for possible conflict.

There are some services that the reinsurers can provide and what direct companies are looking for. Some reinsurers can provide all of these. Some can provide some of them. Some have subsidiaries that can provide them. Sometimes we participate in these. Sometimes we don't. Facultative underwriting is something we've become more involved with and would like to be more involved with. We're seeing daily or monthly benefit amounts beginning to exceed $500 a day, $15,000 a month. These are sizable amounts. We like to look at people who are applying for benefit amounts this big, and we're seeing more of these cases. It also gives us a better opportunity and a chance to judge the ability of the underwriting being done by the direct company without having to do an underwriting audit or review.

Pricing reviews: these are things that are constantly going on, certainly in today's environment. Interest rates have been down. They're slowly starting to creep back up. Direct companies might have different investment strategies. They might be able to cross-subsidize some of their LTC within an asset base, an annuity base. Typically we can see companies using the cash flow from an LTC product line to fund current cash flows while annuity reserves are being held that can be also used for the LTC side. I don't have to liquidate assets from the annuity side to pay off the annuities and then reinvest LTC excess cash at today's current environment. I can keep those old assets and use today's cash flows.

Administration has become one of my issues to focus on because typically we're a second thought for a lot of companies, and the administration is obviously geared toward collecting premiums, paying claims and paying commissions to their distribution source. Yes, we have to do some reinsurance administration. Has anybody designed that one yet? Let's do it on a 12-column accounting pad and send it off. I'll get off my high horse on that one, but from our point of view, our information is only as good as what you give us. We would like it to be great. I'll ask for the world. I'll settle for much less. Hopefully we can both come to an area of agreement so that the administration makes us both happy.

This brings us down to tracking results and trends. We start looking at actual-to-expected first year, second year, very quickly. We look at an incurred loss year analysis, and if we're already behind the eight ball in the first year, it means we have to catch it up in other years, and that's not always the case. Certainly you have to make some interest adjustments, as we all know, in the first few years. Underwriting will weed out and identify the higher-risk individuals. Our expectations will be that we'll pay very few claims in the early years. This could be as simple as two or three or five claims that weren't expected, which can really throw off the results. The actual numbers are easy to get to. We all know exactly what those are. It's that expected basis that we differ on, and, as I mentioned earlier, that's an

area that we're always happy to discuss with a company. We want to address this issue. If I have a different expectation than you do, then possibly the partnership is not aligned, and it's something we need to address.

Actual-to-expected ratios are just part of the early warning indicators. How's the overall business doing? Certainly as we look at some of the products that we reinsured back in 1999 and 2000 when interest rates were 7.25 percent, lapse was 4 percent ultimate. Now as we look at those same products, well, we're not earning that, and we're seeing lapses much lower. Claims might be coming in where we expected, but already we think we have a problem. That difference is very important, and it needs to be addressed. Again, we're trying to be partners. That's what our goal is here.

Some of the early warning signs that we do look at for results and trends, as I mentioned, are frequency of claims and severity of claims. Usually the severity is harder to look at since we're in first, second and third policy durations.
The longevity risk hasn't really come in. As for underwriting and risk selection, as our chief operating officer (COO) likes to say, if you're looking for a fire, go where there's smoke. Typically we'll look at claims in the early durations as part of reinsurance underwriting and claim reviews. For people who claim early, we want to know is it due to a fall, a broken hip, or is it due to dementia? How did we miss that? How did the direct company miss that? What can we do to refine the underwriting and risk selection?

I think everybody's aware that we're seeing pricing from the direct side increasing during the last couple of years. A lot of this is not due to the morbidity being off, but the lapse rates and the investment rates have not been where companies originally priced it to be.

Reserving issues is another area where the pricing practice and modeling might not reflect exactly what the company's doing for its reserves. I might have some claim cost assumptions, and everybody's incurred in the same year that they claim. We don't carry incurred but not reported (IBNR) claims, but in reality we are using an IBNR reserve. We want to know. We want to be part of the practice of, "What are you doing for your actual reserving?" This can cause a big fluctuation in expected results if reserving in the actual practice is different than what was done in pricing.

Disabled life reserves is another area where companies tend to change these as more and more experience is gathered, and it might be on business that we don't reinsure with the company. I'm having fewer of these claims, but more of these. So, my longevity risk has grown. I need to redo my claim factors, and my disabled life reserves on a home care basis have gone up, but on a facility basis they have gone down. We want to be part of that discussion, part of that understanding. We think it's critical for us to understand what the direct companies are doing.

Here are my two bits on a summary. One of our challenges is that LTC is not centrally managed. While our products are innovative and exciting, they seem to still command low sales. It is firmly on the government's agenda. Whether they admit it or not, it certainly is apparent that our government is going to have a little bit of a problem paying for all of the promised benefits, especially as baby boomers hit retirement age. I believe technology can save or ruin us. It can save us if we use the technology as part of our risk selection. It can ruin us if the public uses it against us. Genetic testing is one area where I see concern—I can pay out of my own pocket for a test that can tell me my propensity to have a specific condition. Oh, I think I'll go get some insurance for that. And, again, I think the basic theme of today is that we want to be your partner. We both have the same goals and expectations. We want to make money together. We don't want to lose money together, but we understand that that can happen.

MR. JAMES M. GLICKMAN: There's a lot of stuff that I'd like to ask questions about, but I'm going to limit myself to one small area that you discussed that's of interest. I think this is almost strictly a reinsurer issue. You talked about a couple of the issues relative to companies having to underwrite and to pay claims according to both their guides, and to protect both the reinsurer, and the direct company. Many of the LTC deals that are being done are being done at least at 50 percent coinsurance, and some up to 70, 80 or 90 percent. You also said that you're willing to participate in punitive damages proportionately if they effectively counsel and concur with you. Yet, if you think about the two parts of that—they have to be very judicious in how they adjudicate claims for you to be satisfied with the fact that they're challenging those that are a bit in question, and you need to counsel and concur if they put themselves at risk for punitive damages. How do you balance those two or get the company not to take the attitude especially if they're only on 20 percent of the risk, that, hey, we're just basically going to approve everything versus if they take a more prudent stand? Do you then want them to bring every claim to you to get you to counsel and concur with? I wouldn't think that would be a desire. I'd like to hear the balance of those two items and whether or not the reinsurers are taking a position that they're going to do what works best for them result-wise or whether they're putting in their contract what the expectations are on both of those.

MR. HALE: Basically we don't want to become the claim adjudication shop for a direct company. We don't have the staff or the manpower. We try to do our homework upfront so we understand what the company's processes are. Your point, especially if you do some kind of an extended wait or an excess where the proportions are different, can certainly arise. It might be on any policy with benefit periods over five years. As Jim mentioned, the direct company keeps 70 percent of the first five years, and then it flip-flops, and what can we do? I guess the question really is to try to keep the conflicts low and make sure that the companies aren't basically saying, "Oh, well, the reinsurer's going to be on the hook for 70 or 80 percent of this after five years, so we just go on auto-pay."

MR. GLICKMAN: I'm trying to get at how you resolve the inherent conflicts rather than just on a, well, it's developed, and now we're trying to pick our best position rather than trying to get a forward position.

MR. HALE: Right. We've had that arise, and it is an issue. You try to establish early on what some of those processes are going to be or what the expectations are. I would think typically we might come back and say, "Well, you're on the first 70 or 80 percent of the risk for the first five years." It's an issue. I don't know that I have the answer. We have faced it. Typically we will come back and maybe make an offer. Oftentimes we might feel the reinsurer is not responsible for these extra contractual damages. The company is the one that's going to have its name dragged through the press and receive all the bad PR.

I think you have to face it on each individual case. They seem to be fewer and far between than the typical claim where there isn't anything that is being contested. There are fewer claims that are contested. So, it's hard to make the plan for all of the contingencies that can happen.

MR. ANDREW M. PERKINS: I'm not sure if I caught the full question you had, Jim. I would agree with a lot of what Tim said. I think generally in reinsurance deals it's the intent of both parties that the reinsurer will not be administering all the claims or looking at all the claims. Neither party usually wants that, and the reinsurers in most cases don't have the staff to do that unless they're a third-party-administrator (TPA) operation, which is a whole different ball of wax, and then they should take more responsibility.

The reinsurer's responsibility is primarily to do their homework upfront about how their clients are managing the business. If they buy into their claims practices as well as other things, underwriting and whatever else is involved, then generally you should expect the reinsurer to follow whatever comes out of that in terms of the claims practices. If there's a special structure that puts the reinsurers more at risk on certain types of plans, like lifetime plans, it's up to the reinsurer to figure out whether they are comfortable and still willing to buy into accepting the client's claim practices. Someone might come to us on an exception basis and say, "We don't know what to do with this claim, do you think we ought to pay it?" If we think we can be helpful, we'll try to provide an opinion, and if our opinion contributes to a punitive damage situation, then probably we should be sharing in that liability. That's what the courts might decide even if the reinsurance contract didn't say that.

It seems to me that any reinsurer who wants to deny claims as not having been handled properly is going to have a tough time making that decision stand unless it's really an egregious example of people doing things totally outside the realm of standard industry practices.
Our attitude at General Re is similar in most ways to what Tim was describing, as to the relationship that we'd like to have between a reinsurer and the direct writer. And though I can't speak for other companies, I suspect most reinsurers have a

similar attitude about wanting to have a partnership in the sense of cooperating and working together in the oversight of the business and in making decisions. Even within that framework, there's a lot of room for differences as to how the relationship would work, and my role in this panel is to try to talk about some of those potential differences—who does what in the relationships, who has what authority and how to deal with disagreements. I'm going to be just expanding on some of the areas that Tim already covered.

The topics I'm going to cover are the roles in the relationship; respective things each party is expected to do or not do; the guarantees in the reinsurance contract; who has the authority to make decisions; some comments about expense allowances; dealing with disagreements; and the characteristics of the best relationships.

Who will administer the business? Obviously it's a different relationship if the reinsurer is going to serve as a TPA, whether they have a turnkey program or something else of that type, and that's going to affect other things, like who makes risk management decisions. One of the most critical decisions is whether the reinsurer is expected to play an active, ongoing role in the management of the program from a variety of standpoints: underwriting and claims management decisions, pricing decisions and whether there should be rate increases. This needs to be agreed on up front or you're probably going to have problems down the road. It needs to be driven primarily by the direct company's attitude as to what they're looking for in the reinsurance relationship. Do they want someone to play a role, to provide advice, and do those types of things, or do they want a hands-off relationship?

The reinsurer may also have some strong opinions on it depending on what part of the risk they're expected to take, or how much of the risk, but it really has to be driven by what the direct writer's looking for when it goes out and seeks reinsurance in the first place. Related to that is the question of what resources each company has. It is common for direct writers to approach reinsurers in any line of business, I suspect, because they want a knowledgeable partner. They want someone with people who are experienced in that product line, who know a lot about what's going on in the industry, who know about how to underwrite it, actuarial issues and other types of things. I would say the majority of companies approaching us, and I'm sure other reinsurers, are looking for some input from the reinsurer. Some of them may have plenty of resources of their own, but they want a second opinion. But some don't want those things from their reinsurer. This issue affects the other things I'm going to talk about, things like who has authority to make decisions, and it ties in with guarantees and the other topics as well.

Who takes what part of the risk is also a very big part of defining the relative roles, and it shows up in different ways. It can be different percentage shares. The other terms of the relationship probably are going to be affected quite a bit by whether the reinsurer is taking a minority share of the risk or whether it's taking the

majority. You can have reinsurance relationships that go up to as much as 75, 80, or 90 percent of the business going to a reinsurer. This is almost certainly going to mean the reinsurer needs different terms in the reinsurance agreement as to what it has influence over: underwriting, pricing and so on. And it's not just a question of the percentage share. Relative shares of the risk are also driven by the structure of the reinsurance, whether it's just a straight proportional coinsurance or some kind of an excess deal, say, on lifetime benefits only, or maybe reinsurance of some other segment of the business, just certain types of policies or even certain benefits within the policy.

Reinsurance guarantees: I'm going to be talking primarily about the guarantees the reinsurer provides to the direct writer. But to some extent there's usually a two-way guarantee, though it may not be the same in both directions. The reinsurer thinks about what guarantees it is getting out of the deal as well. First let's address the renewal guarantee, recognizing that most of the business sold in this industry is guaranteed renewable, so the direct writer can't terminate inforce policies as long as the customers are paying premium. The first question I would think a direct writer would ask is whether the reinsurer is obligated to follow that renewal guarantee, to stay on the business.
In fact, the direct writing company may have reserve credit problems if there isn't a renewal guarantee on a coinsurance deal, but other types of reinsurance deals typically have a renewal guarantee on the reinsurance as well. I have heard there are exceptions to this. There have been deals in which some reinsurers provided coverage where, at least under limited circumstances, the reinsurer reserved the right to terminate reinsurance. So, if you're a buyer, or a potential buyer of reinsurance, that's one of the key things to check on.

Premium guarantees are often linked with the renewal guarantees, but the reinsurance relationship raises some different questions. Generally, LTC insurance is not being written on a noncancelable basis, not being written with permanent price guarantees, and I believe what's most common is that the reinsurance follows the direct writing coverage in terms of premium guarantees. More specifically, if the direct writer does not get a rate increase, then the reinsurer doesn't get a rate increase. If the direct writer gets a rate increase, usually the reinsurer follows that rate increase, but other questions come to mind related to premium guarantees.

We have had people come to us asking for noncancelable reinsurance, even though their products were guaranteed renewable. We've had people ask us for reinsurance on just the tail of a lifetime benefit period, or just the lifetime policies, and guarantee that we won't change our price unless they change their price, which on the face of it may seem very reasonable. But you can have situations where the direct writers have very different experience on their lifetime business than the shorter benefit period business. They may not need a rate increase; they may not want a rate increase on their total book of business; and yet the reinsurer needs one and wants one. Or you may find that the direct writers are willing to file for a rate increase to cover that extra cost on the lifetime benefits, but the states won't

approve it because their other business is performing better than expected. So there are detailed questions as to what might happen for certain types of reinsurance structures that it's better for the parties to think about in advance and have a common understanding on.

Another guarantee that is typical is some continuation of new business. Usually that's just for a short period—a couple of months maybe. There are some exceptions where a direct writer for some reason will want a longer guarantee period during which the reinsurer will continue to take new business. I don't think many deals get done like that, but I could see a reinsurer perhaps being willing to go a year, particularly when the reinsurance is first put in place.

Again, with most of these guarantee questions, it's usually a two-way question. On the continuation of new business, if it's 60 days' notice for the reinsurer to stop taking new business, then the direct writer generally has the same right. They can give the reinsurer 60 days' notice as well. So, it's an equal right for each party under agreement.

Renewal guarantees are also typically an equal right. The reinsurer is guaranteeing renewal as long as the policy is still in force, but so is the direct writer. The direct insurance company does not have a right to say, "I'm going to stop reinsuring this business with you, and what's already in force comes back to me." An exception to that is when the agreement includes a recapture provision. Probably everybody in the room is familiar with the idea of recapture. My impression is that they're not common in health reinsurance agreements, including ones covering LTC. Also keep in mind that recapture provisions aren't necessarily an easy contract feature on which to reach agreement on.

A recapture provision that guarantees the return of reserves to the direct writer is a no-win situation for the reinsurer, putting them in the position that if the business performs well, it will probably be recaptured, but if the business isn't performing well, it's not going to be recaptured. If it is recaptured and the client takes the reserves back, and if those reserves have conservatism in them, probably the business didn't perform as well for the reinsurer before recapture as it will for the direct writer afterwards.

It's not a very attractive provision from the standpoint of the reinsurer, and this goes back to something Tim commented on. If there's a desire to recapture it may work better if the two parties need to negotiate the recapture terms and essentially come to a fair market negotiation decision based on what they know at that point in time. This is probably a more workable way for recapture to exist.
Next I'll discuss the authority to make decisions. Should there be a change in underwriting policy or underwriting standards? Should we lower the age at which we do face-to-face assessments? Decisions need to be made about whether a rate increase is needed, or how big it ought to be. These are just examples of things that are important to the ongoing management of the business, things that

someone needs to make a decision about. The reinsurer's role in most situations is it will provide input, but most of these things are usually the direct writers' call on the final decision. That's understandable. It's their agency force; they have the regulatory compliance responsibilities. Most reinsurers would typically not expect to have the final say in these decisions. But sometimes that's going to be affected by other factors.

It's important that this question of authority be decided upfront, and that it is stated in the reinsurance agreement who is going to have the right to make these decisions. It usually is dependent on the share of the risk the reinsurer is taking. If the reinsurer is taking a majority of the risk, it's going to want to have more say in whether there's a rate increase or whether the underwriting standards should be changed. Going back for a minute to some of the prior discussion, that doesn't mean that the reinsurer is going to make all underwriting decisions or is going to make claim decisions claim by claim. But they might want to have more say as to what the procedures are or the standards for the information collected in underwriting. Authority to make decisions might also be linked to who has greater resources with experience in the LTC business.

Expense allowances are usually structured to approximately cover the insurer's expenses. Most of the business that's reinsured in LTC is probably done through a coinsurance structure. For example, if it is a 50 percent quota share coinsurance deal and you're the direct writer, and you're giving me 50 percent of the premium, then I'm liable to pay 50 percent of the claims. But, you have a bad deal, unless I'm also going to give you back basically the part of the premium that was meant to cover the expenses, because you're the one who's going to be paying those expenses. You pay your agent's commission; you issue the policy; pay your premium tax, etc. Reimbursing a proportionate share of those costs is the purpose of the expense allowances.

There are other structures of reinsurance deals that don't involve allowances. For example, a YRT pricing approach essentially accomplishes that in a different way by not giving a gross premium to the reinsurer. You're just giving a net premium for the current year's claims, and because early years' claims are low, you pay very little premium to the reinsurer those years. You keep most of it to cover your expenses. There are decisions to make as to how you structure the reinsurance allowances, and it isn't necessarily a given that they will equal exactly what you think your expenses are, which is why I used the word "approximately." The reinsurance allowances will usually be very heavily front-ended, just as your expenses are, and then closely match your lower renewal expenses, but there are still a lot of choices to make.

To really follow your exact expenses, you have to get very detailed about how the allowances are paid. Some reinsurance agreements do this, having things like claim allowances being a percentage of paid claim dollars, which might be the same format as the way you think of your real costs. But some allowance structures are more simplistic and will just have a percentage of the total reinsurance premium

that's a high percentage the first year and some lower percentage for all renewal years, which, again, approximately covers your real expense pattern, but is not exactly what your pattern of costs is.

One other thing to keep in mind is that the reinsurer has expenses too. Unfortunately, buying reinsurance means there's more expense in the whole economics of your reinsurance program. It may be that the reinsurer swallows that. If the reinsurer reimburses you for a proportionate share of your full expenses, then the reinsurer effectively has a lower profit margin expectation on the deal than you do. Another approach is, if you know you're looking for reinsurance, build something into your price to cover the fact that there is a little extra cost. Typically a reinsurer's expenses shouldn't be anywhere near as high as yours are, but they do have some. If the reinsurer is involved in administration, that would affect the whole expense allowance equation.

Dealing with disagreements: We all want to avoid them if we can, but disagreements come up from time to time. The most important thing is to try to recognize upfront what kinds of things can happen and try to deal with those possibilities in the written agreement between the parties, so if anything comes up down the line, there's a road map for how to deal with it.

The better aligned the parties' interests are, the less likely you'll get into the situation at all, so coinsurance arrangements are the ones where it's least likely you'll have disagreements. If the business needs a rate increase, then both parties are suffering. Both parties are probably losing money, and both parties have at least some interest in a rate increase. That doesn't mean you have exactly the same interests. Again, the direct writer has an agency force it has to worry about. The reinsurer doesn't. You still may not come to the same conclusion, but at least you do have some shared interest in what's going on, and that's a little less true with some of the other structures.

If there is a disagreement, recapture might be a solution. Again, it's hard to lay out upfront a way to do that which is a fair deal for both parties. It's also hard to predict in advance what the expectations for the value of the business are going to be at the point in time there's a disagreement. So it's difficult to come up with a formula to stick in a recapture provision that will cover all circumstances and be fair to both parties. Nevertheless, if there is a disagreement at some point in time, recapture might be an avenue to pursue to resolve that disagreement in the best way.

Arbitration is an option. I'm not aware that it's been used very often in our part of the industry, but the contracts generally have an arbitration provision, and that's a route you can go.

I have just a few comments on our view of the best reinsurance relationships, best in terms of the potential for it to be seen positively from both sides, and for it to

last a long period of time. First of all, it's important that both parties have similar objectives as to what they hope will happen with the business. Secondly, it's better if both parties enter the arrangement with an attitude that it will be a winning situation for the other party. Reinsurers generally recognize that their success depends primarily on long-term relationships, and also that whether they're needed by the direct writer is largely dependent on whether the reinsurer can provide advice and services that are helpful to the direct writer in achieving that insurance company's objectives. If that's the attitude from both sides, it's much less likely you'll have disagreements and more likely it will be a successful program.

You need good alignment, which I mentioned before. More equal shares of the risk help promote a better relationship, one that is less likely to have problems down the road. If rate increases are needed or some other change is needed, whatever the example may be, having the decision authority be related to who has what portion of the risk is the sensible way to go. It's not always the reinsurer that has the greater share of the risk.

MR. IRA SLOTNICK: Are there any statistics as to how big the LTC market is in the United States? How much of that is reinsured in terms of dollar, premium dollar?

MR. PERKINS: I don't know the exact number, but, in order of magnitude, I think the total premium of the direct market is on the order of $8 billion of premium inforce. I'm not aware of any published source that says how much reinsurance there is. Our guess would be it's certainly a minority of that, maybe somewhere between half a billion and $1 billion of premium reinsured. Part of the problem is that the numbers can be funny because there are organizations that reinsure from one of its subs to another sub for different reasons, so it's sometimes hard to pin down what's true reinsurance and what's something else.

MR. SLOTNICK: What brought that question to mind is you mentioned that your pricing needs to take into account reinsurance expenses and probably profit, too. I would guess anywhere from 5 to 10 percent extra in premium for that, and that would put him at a disadvantage in terms of selling his product.

FROM THE FLOOR: It wouldn't be competitive if he would have to add in his reinsurance expenses plus the reinsurance profit.

MR. HALE: Typically the reinsurance profits would come from the direct side's profit. If you're looking for, say, a 15 percent return after tax, after cost of capital, both parties, we do a 50/50 share, sell $1 million, we'd probably have an aligned share. You'd get 15 percent of 50 percent instead of 15 out of the 100 percent. I don't think you add the reinsurer's profits on top of all of your profits. We're going to split the profits.

MR. PERKINS: I would agree. If you're going to try to cover that cost, and nobody absorbs it in a lower profit margin, I still wouldn't expect it to impact the price charged to the consumer by more than 1 percent or something like that, depending on the structure of the deal.

MR. HALE: In regard to the expense allowances, typically a direct company would have some overhead expenses and salary expenses. The reinsurer would have the same types of expenses, but we wouldn't have, as Andy mentioned, the claim and benefit adjudication costs, the commission structure to pay to the agency force, those sorts of things. So, again, if the premium is designed to cover all of the overhead, well, we're going to take our little share of the overhead. You get to keep your share of the overhead.

FROM THE FLOOR: I'm from United Health Actuarial Systems. If you have a typical coinsurance agreement in the definition of expense allowances to the direct writing company, and there is a rate increase, are those expense allowances defined in terms of the original premium or the new premium? Is that negotiable?

MR. HALE: That's a great question. I even wrote that one down as something to probably talk about. It's not always defined ahead of time. Is it the intent of the direct company to continue paying agents compensation on a rate increase? I would say that is probably something that's negotiable because there might be some treaty amendments that would need to be put together to come up with what the expense allowance structure would be. So, I think if the intent is you're not paying these expenses, why would the reinsurer reimburse you for those expenses? If the rate increase was strictly for, say, a morbidity issue and higher claims, the allowances and the expense structure should reflect that.

MR. PERKINS: The latest NAIC model for LTC, which has within it new rules for rate management, for pricing, including rate increases, has a structure that, as you probably know, requires the direct writer to deliver a higher loss ratio on the rate increase premium. That suggests strongly that the direct writer won't want to pay commission on that extra premium, or they're going to have economic difficulties. The reinsurer would expect to follow that by not paying allowances on the extra premium.

FROM THE FLOOR: I agree. Thank you.

FROM THE FLOOR: I wanted to make sure that we didn't just focus on the agent commission aspect, though, because, in addition, some of the expenses in the administration of the business, particularly claims, if you allowed the increased premium that was gained in a rate increase to flow through to the claims adjudication side, you'd be, in effect, rewarding the claim payment mechanism by paying a higher percentage of administration expenses on that, and that also is not intended, I don't believe, in those regulations.

MR. HALE: Well, that's true. Again, that's probably also due to volume of claims. So, whereas I agree with you that you don't want to compensate them for having too many claims, if experience is poor, the number of claims will have gone up, the claim expense has gone up as well. I think that's all part of the negotiation.

FROM THE FLOOR: Let's delve a little bit more into the profit penetration issue that was brought up. I thought it was a good one. I would estimate that the reinsurance marketplace is less than 10 percent of the total marketplace, and yet I view reinsurance as a very large opportunity to increase both sides. I think the reinsurers in many marketplaces help not only with the expertise, but also help to make the market. One of the issues that was brought up was the profitability, and in actuality, if things were all measured on a percent-of-premium basis, which they aren't very much anymore, that would probably have a legitimate issue. But they're being measured on an ROE basis by most companies. What has caused the problem up to now of there not being more reinsurance in the marketplace and there not being more carriers in the market is that the ROEs on LTC have been pretty lousy. Some of it has been caused by companies that are not doing it right. Some of it's been caused by the risk-based capital. And some of it's been caused by various other scenarios and perhaps even unreasonable expectations of how high they should be. But my sense is that with the new rate stabilization model and with prices going up significantly in the LTC marketplace, there is a significant opportunity for both the reinsurers and the direct insurers to get the right kind of ROEs on this product.

If there's a disconnect now, it's on the technical areas. The reinsurers have an obligation to get this information more out to the direct carriers, how they can properly underwrite, how they can claim adjudicate, and how they can properly price so that there will be more direct carriers in there and more interest in reinsurance. I wanted to hear your comments about this whole thing.

MR. HALE: I agree. Your shop is set up in a specific way so we might not have some of these services that are being requested. We have direct companies asking us: "Will you be willing to invest $500,000 as we put together our shop and are looking for part of the upfront cost of getting into the business?" We might not be willing to do that because we need to recoup our money just as well as you do, but we may not have the same say over how things are done.

I certainly think the turnkey product is a way to bring companies into this market for a fairly minimum cost, and if a company doesn't want to make the upfront investment into creating an underwriting shop and hiring the compliance, these things can be shopped out as well. I'm thinking of the life insurance business. I don't know that the reinsurers are bringing the products to the direct companies, but this might be an issue that can be addressed and where we could participate more, whether or not we do.

MR. ROBERT K. YEE: Do you see more requests on quota share versus stop-loss type?

MR. PERKINS: We certainly do. It's always been true that most of the requests we get are for a straight proportional participation. We have done some deals that were a different structure, but the majority of the reinsurance business we've written and that's been requested has been quota share, and that's still true.

MR. HALE: I would agree with that, but I would say also, Bob, that we are seeing more companies concerned about management of that longevity risk and the lifetime benefit periods. So, we do get more and more requests now. Again, we're trying to spread our risk as well. We have not been offering just extended-wait coverage for the lifetime benefits because, as Andy mentioned, it starts to remove the alignment of interest, per se.

MR. PERKINS: Bob, you used the term stop loss. Were you specifically asking about that?

MR. YEE: Yes.

MR. PERKINS: At least in terms of an aggregate stop loss, my impression is there have been very few of those deals done in LTC. We might have gotten one or two requests over the years, but it's very rare. I think a stop-loss arrangement is particularly difficult with a line like LTC where most people's concern is not what's going to happen this year or in the next five years, but what's going to happen over the next 30 or 40 years. Dealing with the uncertainties of what may happen over 40 years is a challenge.

FROM THE FLOOR: How about tail risk versus coinsurance? In other words, are a lot of people asking for excess coverage?

MR. PERKINS: Something to protect them on the lifetime benefit period? Yes, we do get those requests, although I still wouldn't say that's a majority of the things coming to us.

FROM THE FLOOR: I'm not even sure I understand YRT reinsurance exactly. I get the impression it would be based on the claim cost in some way, which in the early years would be next to nothing, and would still carry a huge investment component because once you have a claim. It goes for many years. What's the motivation for it? It still has a big investment component. So why do it at all? Why not just coinsure?

MR. HALE: Well, it does, but it has a smaller investment risk, I think. Typically I'm reinsuring the claims that are incurred in year one, and I only expect they'll run off a majority of them within the first couple of years. So you might have very small amounts. The duration of the investment is much less than pre-paying on a level-

premium basis where I don't expect to pay out a majority of my claims until 15 or 20 years from now. In year two, my premiums go up on a YRT basis as the reinsurer—for claims that are incurred in just year two. It's very much like a mortality YRT risk. You are just insuring that morbidity risk for claims incurred in that specific year.

On an overall basis, it does not have the same duration that a typical level-premium funding, pre-funding, would have. As you mentioned, I expect very little claims, so I'll have very little dollars to invest over the next couple of years. Pre-funding allows me to invest it over a 15- or a 20-year horizon before the majority of claims. Now from a direct side in 10 or 15 years, as I mentioned, are those YRT premiums—what's being paid by the customer. The direct company is taking active life reserves as well as premiums to pay that YRT premium, but it still has a smaller horizon on that investment, because if you use the typical agents, the average claim is two-and-a-half years. Most of your claims that will be incurred in a specific year have a short-term duration. But you're right. There are some that will go for a very long period.

MR. PUMMER: We haven't talked about tax implications at all, and I was hoping we could discuss just briefly some deferred-acquisition cost (DAC) tax implications, and then also if there's any reinsurance solutions for excess tax reserves.

MR. PERKINS: Well, the DAC tax pretty much is the same for any line of business. My understanding is the IRS regs do specify how DAC tax gets shared between the reinsurer and the direct writer, and it's based on net consideration. The net cash flow going from the direct writer to the reinsurer is part of the reinsurer's calculation of its DAC tax, and it's an offset, or reduction in the direct writer's DAC tax. In the early years when cash is generally going from the direct writer to the reinsurer, and the reinsurer's building up the active live reserves, there's a DAC tax liability to the reinsurer. Eventually the cash flow goes the other direction.

MR. HALE: There is a little bit of a DAC tax misalignment. I know from the reinsurer's point of view it is on net cash flows, and we typically will reflect sort of any advantage or savings we have in what our profit targets and goals are. It typically gets reflected in our pricing from a reinsurance point of view. It might be a little bit of a disadvantage from the direct company if it does not do some of the upfront analysis of what would my business look like before reinsurance. What does it look like after reinsurance? On some basis it can reduce the expected returns from a direct company if it has not done that exercise.

MR. PERKINS: The other part of your question about tax reserves being higher than stat reserves—I'm not a tax expert. My understanding is that for the reinsurer to be able to reduce that cost impact they probably have to take the business offshore, have it end up somewhere that isn't subject to the same taxation basis. Put it somewhere in an entity that's not a U.S. tax entity. In going offshore there may be other things that also can be done differently, like greater flexibility in

investments that can be used to fund or to support the LTC line, but going offshore raises other kinds of issues about reserve credit and credit risk. I don't know how much of that is done in LTC.