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Retirement cont'd

down gradually, rather than abruptly retires, there will need to be changes in services and job patterns. One possible new service would be temporary employment services focused on helping people with this phase-down. Some companies now are doing this through internal retiree pools.

6. Are there special issues relating to healthcare and retirement?
Historically, retiree health benefits have not been a high priority in most employers' planning for their employee benefit programs. Virtually no employers covered much long-term care in their health benefit plans. However, in the last few years, a few employers have introduced voluntary long-term-care arrangements, through which their employees could purchase long-term-care insurance on an employee-pay-all basis.

Benefit needs analysis focused on retirement benefits has not looked specifically at the issue of retiree health benefits. Rather, the emphasis has been on retirement income, which is appropriate when the health benefits are continued into retirement with the employer paying for the benefit on the same basis as for active employees.

The symposium included structured workshops on issues related to public policy, private sector products and services, and the workplace. Four case studies were developed for these workshops, which consisted of 20-30 people. Each workshop group was divided into smaller groups for discussion.

An analysis of the responses to the questions above indicates that the issue of the future of retirement is complex. Many forces will affect it, including some that at first may seem unrelated. The materials presented at the symposium gave participants the opportunity to examine these forces from a broad perspective.

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A regulatory framework for long-term-care insurance

by Larry M. Gorski

Meeting the needs of an aging population is a challenge for those involved in health issues. As an actuary in state regulation, I am working to ensure that any products developed by private insurers to meet this challenge are secure, fairly priced, and properly disclosed to purchasers. This article will discuss what I perceive to be the key actuarial issues relative to long-term-care (LTC) insurance benefits sold in conjunction with life insurance.

I have limited the scope of this article because of the newness of this approach to funding LTC benefits and the lack of a regulatory framework for the product. This discussion assumes that any legal issues concerning the approvability of the product have been answered. Also, I am limiting this discussion to LTC benefits and excluding dread disease-type benefits.

From a regulator's viewpoint, the two key actuarial issues are insurer solvency and policyholder equity. Without the reality of insurer solvency, prefunding LTC benefits through a private insurance mechanism is meaningless. Diversity in product design and lack of insured population data have made the solvency issue a regulator's nightmare but an actuary's delight. The issue is a regulator's nightmare because the underlying life product used in these situations is some form of universal life insurance, which in and of itself is surrounded by many open questions. Proposed reserve methods for the additional LTC benefits have ranged from "adding nothing to the basic policy reserve" to "developing a traditional prospective valuation formula using assumed annual claim costs." Rigorous analysis of benefit features, including the impact of waiting periods before benefit eligibility, should be performed.

The arguments for a particular method are often no more than an exercise in "hand waving." While a particular reserve methodology might eventually be chosen on the basis of practicality, the reserves computed on this basis should be least as large as reserves based on a comprehensive multi-decrement analysis utilizing the best available data to support the various assumptions, including incidence and continuance rates. Lack of published insured population LTC data makes the need for monitoring the adequacy of the reserves an obvious necessity.

The question is how should this be accomplished. My view is that an ongoing actual to expected analysis should be performed. Many actuarial issues must be addressed to implement this idea. For example, should separate analysis of incidence and continuance rates be performed, or should the analysis be based simply on incurred claims? How should the impact on the underlying life benefits and reserves be handled? How should the results be reported to regulators? A complicating factor is that the charges for LTC benefits are not always explicitly displayed but incorporated into an overall cost of insurance charge, which includes both mortality and morbidity.

The usual solution to equity issues is through nonforfeiture values. Even though there might be situations in which nonforfeiture values for LTC benefits sold in conjunction with life insurance might seem obvious, I feel that at this point in the development of the product, solvency and disclosure concerns are more fundamental. Variations in benefits, benefit eligibility requirements, and the impact of paying LTC benefits on life insurance benefits make appropriate disclosure crucial. However, one idea that appears to have some support is to require paid-up benefits, but not cash values, upon lapse of the LTC benefits.

Loss ratio requirements are an integral part of any regulation dealing with health benefits, including LTC benefits. This approach to policyholder protection doesn't appear to be necessary when dealing with LTC benefits that are an acceleration of death benefits but does appear to be appropriate in other circumstances. My view is based on the premise that LTC benefits that are an acceleration of death benefits are incidental to the death benefits.

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LTC regulations cont'd

As competition between companies causes benefit enhancements to take place, my view of the scope of the benefit might change.

The regulatory framework is not being developed in a vacuum. An exposure draft of amendments to the existing NAIC Model Act and Regulation is available for review and comments. Interested actuaries can contact the NAIC office for copies of the exposure draft.

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AFIR colloquium set next April in Paris

The International Actuarial Association (IAA) has authorized organization of a new section called The Financial Section (AFIR). In American jargon, the focus is on investments.

With the internationalization of financial markets and operations, the increasing sophistication of financial techniques and products, and the deregulation of financial markets, actuarial methods are becoming more appropriate as tools for management decision making.

To attend the 1990 colloquium as a member of IAA, you must join IAA in the class of 1989 (June 30). With this mailing of *The Actuary* is the application for IAA membership. Be sure you respond before the cut-off date! Dues notices were mailed to present IAA members at the end of April.

AFIR's purpose is to address financial issues of concern to actuaries such as the latest valuation and hedging techniques in financial risks. Members have the opportunity to exchange experiences and knowledge with their foreign counterparts and to have regular contact with financial academics and researchers.

AFIR section activity consists of publishing reports and organizing colloquiums.

The first AFIR colloquium will take place in Paris April 23-27, 1990, and is organized at the joint initiative of the French Actuarial Associations and the AFIR section committee.

Financial actuarial papers will be published in the ASTIN bulletin; ASTIN is another IAA section.

Editorial

Managing the capital squeeze

by Richard K. Kischuk

Recently, the media has begun to focus on the "capital squeeze" facing the life insurance industry. The February 20 issue of *National Underwriter* reported on a study just completed by Standard & Poor's: "The life insurance industry is caught in an unprecedented squeeze on capital... Management can no longer brush aside the issue of capital adequacy." According to the March 20 issue of *Best's Insurance Management Reports*, a review of the life/health industry's experience during the past 10 years indicates the industry-wide C&S-to-L (capital & surplus-to-liabilities) ratio improved for a three- to four-year period but then began to deteriorate again.

The life insurance industry seems caught in a vicious cycle of intense competition. While it's not comparable to the financial crisis in the savings and loan industry, there's cause for concern.

For example, let's look at recent experience with interest-sensitive products. The profit margins of nontraditional life insurance products have been shrinking. This has motivated companies to increase their exposure to junk bonds and to adopt other riskier investment strategies. At the same time, companies have increased their leverage in order to show higher returns on equity (ROE). By maintaining artificially high ROEs, the industry attracts still more competition. This, in turn, leads companies to adopt even more risky investment strategies and to leverage further.

Another form of leveraging has been the pyramiding of capital, intended to further increase returns on equity. Increasingly, the surplus of life insurers includes large illiquid investments in subsidiaries, rather than securities that can be liquidated to pay claims if adverse experience develops. Many of these downstream companies are themselves insurance companies, whose surplus should not count toward the capital position of the parent. In addition, many insurers have experienced sizeable losses by expanding into new lines of business, such as financial services and managed healthcare. In many cases, the losses from these businesses will continue for many years, and the present value of these losses represents a significant impairment of statutory surplus.

The increased severity of the health underwriting cycle also has taken its toll. Many life-health insurers had leveraged themselves to support rapid growth in interest-sensitive products. This occurred at the peak in the underwriting cycle, and large health losses caught these companies at a bad time, causing many to lose their ratings.

While many industry experts are calling attention to the "capital squeeze," other observers blame the life insurance industry's problems on "overcapacity." Actually, the situation is caused by leveraging. The term "overcapacity" implies that large amounts of new capital have been flowing into the industry. This has not been happening. Instead, companies have decided to assume increasing amounts of risk using the capital base that is already there. This, in turn, has driven profit margins downward, creating pressures to leverage still further in order to show attractive returns on capital.

With these trends in place, it isn't surprising that few life insurance companies are creating economic value for their owners. A recent study of 17 publicly-held life insurers showed that from 1982 to 1987, only six companies earned significantly more than their cost of capital. The rest were breaking even at best, and several were destroying economic value. Moreover, the cost of capital is rising for many of these companies because of increased leverage in their capital structures.

How can life insurance executives cope with the "capital squeeze"? Here is a brief list of strategies that most companies can follow.

1. Aggressive management of expenses

It isn't news to most insurance executives that there is plenty of potential to reduce expenses. Today's products

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