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Reinsurance for Long-Term Care Insurance

by Gary L. Corliss

Reinsurance, in its simplest terms, is insurance for an insurance company. From its earliest days in London, insurance was consummated through a pooling of interests by those who were glad to contribute a small sum of money to protect themselves financially in the event that a catastrophe struck one of their ventures. This pooling of interests has expanded globally to cover almost every risk of mishap imaginable to an individual or his properties.

Mishaps can also occur to insurance companies. Thus, the advent of reinsurance.

How does reinsurance work? Simply, the insurance company pays the reinsurance company a portion of the premium received from its insured customers. Later, the reinsurance company pays the insurance company for reimbursement of benefits to its claimants.

Why Reinsure Long-Term Care Insurance?

Nearly all the major U.S. writers of long-term care insurance (LTCI) and the majority of those writing long-term care policies around the globe have in the past, or are now, reinsuring some portion of their LTCI portfolios. There are various reasons why they do so, primarily:

- stabilization of earnings
- access to surplus for growth
- access to knowledge
- access to functional services

Stable earnings are important in today's financial services world. Direct writers understand the need for impeccable financial statements. Rating agencies react favorably to predictable financial results. They react unfavorably to wide swings in results. Rating agencies frequently recommend reinsurance to LTC insurers.

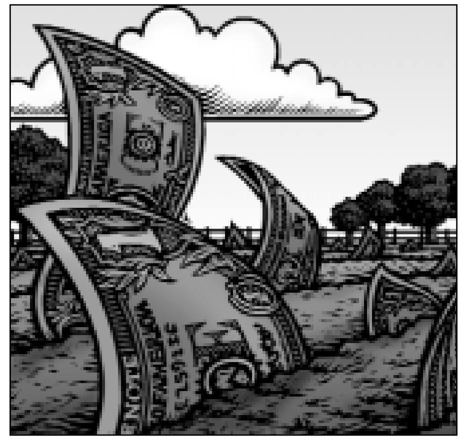
Customers are more comfortable placing their security with a well-rated company. Financial analysts and potential investors likewise will choose to invest where corporations demonstrate smooth earnings growth. LTC reinsurance can help remove the bumps in earnings.

Access to surplus for growth is the second reason. Since the concept of Risk Based Capital arrived for insurance companies, access to capital and use of surplus have become very important. An insurer should grow its LTCI portfolio rapidly in order to achieve a spread of risk.

Where there are large initial expenses (due to first year marketing and underwriting costs), the LTC reinsurer can assist in making funds available so that the writing company does not deplete its own capital. Thus the insurer's surplus position is enhanced — not disadvantaged — due to rapid and expensive growth.

Access to knowledge about the LTCI products and processes is probably the single greatest reason an insurer would have a partnership with an LTC reinsurer. A quality reinsurer will have a number of reinsured LTCI clients. If the reinsurer is close to its many clients, it will have extensive information about the real workings of the LTCI industry. Without divulging confidential information, the reinsurer can help its clients avoid difficulties that other companies have experienced.

The reinsurer's knowledge may relate to risk issues (e.g., how to determine premium for a new shared care benefit or determine impact on select morbidity factors due to underwriting worksite employees) or it could be called on to



generate successful marketing strategies, develop internal processing activities, or assist with various training concerns.

Lastly, access to functional services (e.g., pricing, filing, underwriting, and claim adjudication) can make or break the profitability of an LTC insurer. A new entrant to the LTCI market place can inexpensively secure "best practices" from a reinsurer with a broadly experienced staff. LTCI direct writers already in the market can gain access to services or assistance on difficult filing, underwriting, or claim situations.

Types of Reinsurance

All reinsurance arrangements do not operate in the same manner, so it's important to understand the types of reinsurance available. Different forms of LTC reinsurance serve different purposes. An insurer should select the type or combination of types that best suits its objectives.

Although many reinsurance arrangements are possible, only four forms are commonly available to direct writing companies.

Proportional quota-share is the most widely offered form of LTC reinsurance in the United States.

(continued on page 16, column 1)

Reinsurance for Long-Term Care Insurance

continued from page 15

In this arrangement, the insurer and reinsurer share in all the risks of the product, including claim and benefit costs, persistency, investment, expense and mortality risk. A reinsurer also shares in the impact of mandated benefits and state regulation on the profitability of the reinsured policy forms.

The extent of the risk sharing is proportional to the reinsurance ceded. For example, in a 60/40 relationship, the insurer retains 60% of the risk and cedes 40% of the risk from the first dollar expended. The reinsurance premium is calculated by subtracting an expense allowance from the gross premium paid for those covered. The allowance covers the ceding company's expenses for commissions, marketing, state and local premium taxes, overhead, selection and issue, administration, and claims processing. The reinsurance premium covers claim benefits and the reinsurer's expenses and profit.

Proportional claim-only reinsurance protects the insurer from adverse experience in claim benefits only, including the risks of higher claim frequency and longer claim duration than expected in the pricing. Coverage for both risks is important for a new product in which the incidence rate and the length of claims are still unpredictable. As with proportional quota-share, the extent of the risk sharing is stated relative to the reinsurance percentage. In a 60/40 relationship, the insurer retains 60% of every claim and cedes 40% of every benefit payable.

Excess-of-loss reinsurance is a subset of proportional claim-only reinsurance. It is used when the insuring company is concerned with a single aspect of the claim risk. For example, the carrier may be willing to accept many claims, but only those of short duration. If the claims are lengthy or large, the insurer may want to reinsure all or a significant portion of the benefit payments.

The excess-of-loss approach may apply to time or benefit amount. One insurer, for example, may be willing to retain the risk for all claims paid after the elimination period and during the first year of benefit payments for any one insured. In this case, in a $100-per-day policy that incurs a claim of 1,000 days, the insurer would pay the first $36,500 in benefits, and the reinsurer would pay the remaining $63,500 in benefits as they came due. For the same claim scenario, if the carrier were content to accept $50,000 maximum benefit per insured, the assuming reinsurer would cover the continuing payments of the second $50,000.

Portfolio aggregate stop-loss reinsurance provides potentially high reimbursement with a low probability of need. With this arrangement, the carrier's claim losses for a particular year for all the policies of a specific policy type will be protected against exceeding a certain amount, the stop-loss point.

The stop-loss point is expressed as a percentage of expected claims. For example, the reinsurer may cover claims for a calendar year if they exceed 150% of a certain amount, called the attachment point. Based on the mix of policy features, attained ages, sex, and policy duration, it may be determined that the insurer should have $210,000 of incurred claims for the calendar year. In this case, the 150% attachment point would be $315,000. If claims incurred in the reinsured year were to require benefit payments of $400,000, the reinsurer would pay $85,000 of the $400,000. The reinsurer incurs the liability in for the year in which the claim began but makes payment after the insurer's payment of the first $315,000.

For insurers advancing into the LTCI market, significant risks can be substantially lessened with a sound reinsurance partner. Access to expertise, varied services, and financial protection offer direct writers a level of assurance that may facilitate their entry into or expansion in the long-term care insurance market.

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