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Reinsurance:

Sharing More than Morbidity Risk

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As insurance professionals, we know that insurance supports the entrepreneurial spirit of american businesses. It helps the "mom and pop" shops and it helps large corporations. Similarly reinsurance supports the entrepreneurial spirit of small and large insurers alike.

Long-term care reinsurance during the 1990's is a case-in-point. Reinsurers normally depend on direct writers for their distribution systems and they are willing to assume risk and offer other services to attract them. Long-Term Care Insurance (LTCI) reinsurance during the 1990s involved the sharing of morbidity risk, the sharing of other important peripheral risks, the sharing of expertise and the sharing of financial resources.

Sharing morbidity risk

When companies first entered the world of the unknown LTCI risk, unknown even with large exposures, they often sought to avoid low-likelihood, yet potentially high, losses. Early LTCI products did not offer lifetime benefits. As more consumers sought that product feature, insurance companies turned to reinsurers to help mitigate the long-term exposure. At least one company issued lengthy home health care benefit periods on stand-alone home health care and comprehensive long-term care policies only after obtaining reinsurance on benefits that exceeded a certain duration or dollar limit. The reinsurer charged a premium greater than the expected value, yet the direct writer willingly paid the reinsurance premium knowing that under the unlikely scenario that the lengths of service would be longer than expected, the exposure might be greater than their surplus could handle.

Sharing other risks

There are other risks that insurers sought to avoid or share because they represented a significant aspect of the profitability objectives. For example, some insurers understood that their returns on investment were sensitive to their investment yields and they sought to hedge the returns with reinsurance, which was designed to return the underwriting profits and a guaranteed return on the associated assets.

Sharing of expertise

Since few insurance executives, managers and personnel had expertise in long-term care, some reinsurers offered turn-key services where they would provide the policy language, the pricing, the underwriting and/or the administration to the direct writers who retained some risk and provided the distribution networks. Sometimes reinsurers had the expertise and personnel to perform the functions themselves. Other times they subcontracted the work to third parties.

Also, underwriting is a good example of how reinsurers shared expertise even without turn-key services. Insurers could obtain valuable underwriting advice, and sometimes even underwriting manuals, from reinsurers.

Sharing financial resources

Often, small insurers seeking a unique niche in the senior market needed to reinsure the risk in order to avoid exposing themselves beyond what their surplus could support. These same insurers often needed to pay higher first-year commissions in order to attract agents. The additional expense placed even more strain on the limited surplus.

Furthermore, the surplus strain was not always limited to the first policy year. Statutory reserve margins are so high that the strain was often visible in the mid-durations around the fourth through eighth policy years. In addition, the extra tax on non-qualified forms in the second year made life all the more difficult for that segment of the sales. (Reserves on non-qualified forms are based on a two-year preliminary term basis for taxes, while they are on a one-year preliminary term basis for statutory reporting. Reserves on qualified forms are on a one-year preliminary term basis for both taxes and statutory reporting).

Sharing the Role of Consumer Protection

Reinsurance has been a big factor in the growth of long term care insurance, and has also had an important role in protecting the consumer from inadequately underwritten, administered, and priced long-term care insurance policies since the late 90s. The NAIC was not patient enough to see the impact that reinsurance would have, yet most reinsurers shared the same concerns as most departments of insurance and most direct writers. The original pricing assumptions, while reasonable in the early 90s, were not bearing out in actual experience only a few years later.

Many changes occurred in the long-term care provider system, and simultaneously, policies evolved to the point where benefits were not improving enough to encourage insureds to lapse a policy in order to purchase better coverage. For example, policyholders were willing to lapse a nursing home-only policy with a three day hospitalization requirement to purchase a policy with home care and assisted living facility benefits. They are not as likely to do the same for the newer "bell and whistle-type" innovations. Also, pricing assumptions for assisted living facility benefits were primarily based on judgement because data was not available to provide empirical support. Home health care provisions increased significantly with utilization often greater than anticipated, and with care management savings smaller than anticipated.

Reinsurers took the lead in trying to protect the industry from future pricing difficulties by carefully reviewing the pricing, auditing the underwriting, and in some cases, auditing the claim administration of the direct writers. These are all actions that were serving to guard the consumer from rate increases due to moderately adverse experience.

Reinsurers have even introduced new technologies to the LTCI industry. One of the early uses of face-to-face underwriting assessments was wrapped into reinsurance coverage. The underwriting assessments were touted as being able to reduce early duration cognitive claims. In order to prove this assertion, the reinsurer paid for the assessments and reinsurance was provided only to individuals who passed the face-to-face assessment. Today, it is a common LTCI underwriting practice to use these assessments.

In conclusion, the German poet, J. W. Goethe wrote of government and of the governed:

> "What government is best? That which teaches us to govern ourselves."

LTCI reinsurers have been the teacher of the LTC Insurance industry. Certainly, the industry has had growing pains, yet the state regulators will do well to give LTCI reinsurers room to bring the industry to maturity. ♿

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