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Session 68TS
Reinsurance Strategies for Long-Term Care

Track: LTC/Reinsurance

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Summary: This teaching session deals with the use of reinsurance in the strategy of carriers' approaches to the long-term-care marketplace.

Mr. Mark D. Newton: I am the vice president of American United Life Reinsurance Management Services. Before that I was at John Hancock for several years building its long-term-care (LTC) program. I have with me Michael Kleinman, director at Golden Rule Insurance Company; Tim Hale, assistant vice president at Munich American Reinsurance; and Jeff Poulin, senior vice president at London Life Reinsurance Company.

Let me give you an overview of the session. Primarily, we want to talk about the connection of reinsurance to an LTC strategy. Sometimes companies will create a business strategy but not consider reinsurance in their thinking at the same point in time. Reinsurance is an add-on at the end. I'd like to show you why that may not be the best approach. I also want you to have the reinsurer's perspective of the LTC risk. Jeff and Tim can do that and give you some examples of the uses of reinsurance throughout the LTC industry.

Reinsurance is a creative opportunity, and there are many different kinds of programs. Some of these could fit into your LTC strategy, either to help you get into the market or to enhance the performance of your existing block of business. I am going to talk more about the market potential of LTC later, and some of our panelists will follow up on that as well. For most of you here who are already in the LTC business, you know the growth LTC has seen over the years. And if you think about the baby-boom generation as it moves through into the key LTC buying

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years, it's hard to deny the market opportunity. There are more statistics about that later on.

Why look at LTC? If you have insufficient growth in your other lines of business, consider that LTC sales have gone up 20% a year for the last 4 or 5 years. Maybe you are happy with your growth rate. For example, if your traditional life portfolio sales are exploding, you could skip this part of the presentation. But if you are not happy with your growth or you are just considering other lines of business, I would suggest you consider LTC.

I also believe that LTC can help the retention of your distribution system. Distribution systems need products to sell, and LTC is one of them. It covers a key life-cycle need, which your career agents or your nontraditional distribution systems could use as well. It should be a part of everyone's risk management portfolio. By giving your agents more products to sell to your customers, you can help retain your agents. In fact, there are companies that start their new agents with LTC as the first product in their portfolio and then bring them through the other coverages as they gain experience.

LTC can also enhance the performance of your other products. If you have LTC integrated into your product portfolio and your operations, I can show you some ways LTC can make your other operations more effective, spread your fixed costs over a larger base, and actually improve the performance of certain parts of your operations. Don't think of LTC as a stand-alone product. Think of it as a product that (1) fits your core customer needs for risk management, (2) assists in retaining your agents or makes your distribution system more effective, and (3) enhances the performance of your other lines of business.

Let me talk about commitment. Going in and out of a market, either because your results are not quite what you expected or because sales did not happen, can be very damaging to your company. It can be damaging not only in terms of your reputation but also because of what it says to your agents. If they are not sure that you are backing the line of business they are selling to their customers, then they may not even get started.

You have to demonstrate commitment to them up front. That is one of the keys that will help bring sales. Being in and out is very damaging at worst and wasteful at best. What I also mean by commitment is all the characteristics of your company that determine how integrated LTC is in your portfolio. I am not talking about LTC as merely 1 product amid 20 other products. I am talking about an LTC product that is fully supported by training, product updates, and convention credits or an LTC product combined with an annuity or life product, if that is better. In either case, you want a product that is fully integrated into your operations, helps retain your agents, improves the efficiency of your operations and your sales, and spreads your fixed costs.

Improving sales and spreading fixed costs are key benefits of LTC. Expertise is a key success factor, and scale can overcome barriers to entry. We talked about LTC's superior growth potential. The market is large, is still growing, and has fabulous potential. The baby boomers are somewhere in their 40s and low 50s now. The key LTC buying years are from 60 to 75. People are coming into the key LTC-buying years. LTC sales, as good as they are already, appear poised to get even better over the years.

The Holy Grail of insurance products has always been the complete life-cycle product—something that would cover you from the time you start thinking about insurance in your 20s until the time you die. LTC is part of that life cycle, and although an LTC product combined with another product doesn't completely cover all needs, LTC can fit into that life cycle. Somewhere between an annuity and death is an LTC need. Combining LTC with other products really does make a lot of sense, because it stretches out the usefulness of one product to cover a customer's need.

LTC can enhance a relationship among a customer, an agent, and a company. Let's face it: If a customer is looking for an LTC product and you don't have one, that customer probably won't buy other products. But if you have a product line that includes LTC, then you have a better chance of getting that customer, retaining that customer, and selling him or her something else.

Many of the top-quality companies that offer LTC in today's marketplace have very low lapse rates, in the 1–2% range. Most insurance and financial products would love those lapse rates. Retaining a customer through an LTC policy is demonstrable. How can we take advantage of that opportunity? Here is where LTC can increase the efficiency of your operations.

First of all, let's think about investments. LTC can improve your investment reach. LTC occupies the very long end of the duration spectrum. The liabilities are very long, and some of the assets need to be very long as well. With LTC you can look at longer deals than you have in the past. If you have another portfolio, universal life as an example (which is probably shorter in nature), you can start to think about longer deals and capture some of that risk premium. Or you can look at larger deals to split with another product line whose investment needs are long as well. Other examples might include aspects such as quality, asset types, or private placements. LTC can enhance the operations of your investment department.

LTC is a product with a very dependable cash flow and excellent sales potential. It can increase your economies of scale. Product companies that offer a wide range of products can spread their fixed costs over a larger base.

There is probably no characteristic of your company that should keep you from offering an LTC product. Any characteristics that may affect your decision to offer LTC can be mitigated through the use of reinsurance. As an example, the decision to be a distributor or a manufacturer is a company characteristic. Are you primarily a company that gets paid for distributing, and you leave the product manufacturing and risk to somebody else? Or are you primarily a company that concentrates on manufacturing products and then tries to find many distribution channels to push them through? With LTC you can break these up very easily. You can be a distributor and cede off all the manufacturing and risk to reinsurers. You want to look at the size and breadth of your distribution system. Also, consider the breadth of your product line. What about your brand recognition? Can LTC be used to extend your brand?

Most insurance companies think they are successful at manufacturing products and think they are wonderful at distributing them as well. They do it all. They sell, underwrite, and do the service and the claims. They do everything. In the future, doing everything may be less common as companies look to outsource particular parts of this value chain.

LTC is health insurance. In health insurance there is income variance from quarter to quarter. Claims don't always happen in an orderly fashion. Your company will have ROE or ROI standards, which are hurdle rates that you will have to meet. And your company has fixed costs that it has to spread over a variety of product lines.

Reinsurers can help with the income-variance issue. They can work with distribution and manufacturing issues. They can get you into the business if you don't have the size or scale or expertise to do that. In short, there is almost no characteristic that reinsurance somehow can't help you think about in your strategic LTC plan.

A few things are important in LTC. One is expertise. While LTC is a mainstream coverage now, I don't think the industry has the breadth of expertise available that some of the other lines do. But one of the things that reinsurers offer is expertise. Reinsurers can help define your competition, design policy features and language, set benefits and riders, find or coordinate care management, and create the specialized underwriting you will need—for example, the vendor network for interviews that LTC requires. You will need some claim expertise that includes some care management and a provider discount network.

Another important factor is scale. It is possible that many companies avoid LTC because they just don't have the mass or the scale. You will need to have some research and development money for this business. You will need to think about asset segmentation and duration management. LTC is highly regulated under normal health-insurance regulatory agencies and as a product whose primary consumers are older people. A reinsurer can help with all of these obstacles.

Capital is expensive. LTC insurance is primarily distributed through an individual network or a career sales force that is compensated up front. You need to allocate such capital or think about how reinsurance can help.

Let's review. First, the LTC market growth and opportunity are really too large to ignore. Its sales have grown rapidly over the last five years, and the baby boomers haven't even gotten to the key long-term buying years. LTC can enhance the performance of your other products and your operations, and it can help retain your distribution people. There is no company characteristic that I can think of that should keep you from strategically adding LTC as a part of your portfolio. While there may be plenty of characteristics you must consider, almost all of them can be mitigated or eliminated through the use of reinsurance. Also, reinsurers provide needed expertise and help with capital. And if the reinsurer has a TPA, the TPA can provide you some instant scale for getting into this business.

Mr. Michael Kleinman: I want to discuss some reasons to consider entering the LTC insurance market, ways a carrier can choose to enter the market, how reinsurance can facilitate a carrier's LTC strategy through risk reduction, and how reinsurance can be used as an information source.

There are a number of reasons to enter the LTC market. Among them are demographic trends. According to the U.S. Census Bureau, the U.S. population has approximately 35 million people age 65 or older today. This is projected to double over the next 30 years to 70 million people. Senior citizens utilize LTC services more than the general population, and the number of senior citizens is going to double in 30 years.

I need to comment about some of the statistics that are going to be presented by the panel. We have assembled statistics from various sources. We believe them to be very good, but statistics can differ from source to source. From 1946 to 1964, 76 million baby boomers were born. There are approximately 10,000 baby boomers reaching age 50 every single day, and more and more people of this generation are beginning to realize that not only will they not die before they get old but also that they are likely to live for many more years to come. With each year, there is an increasing likelihood that they will ultimately need some form of LTC. Some of these baby boomers are seeing their aging parents confronting this issue today.

People are living longer, and more people are reaching the ages at which the need for LTC is the greatest. At the beginning of the century, life expectancy in the U.S. was 47 years. It reached 62 years when Social Security was enacted in 1935, which is apparently one of the reasons that the Social Security age was set at 65. It rose to 71 years by 1970 and is expected to reach 78 years in the very near future. According to the 1983 group annuity mortality table, a 65-year-old man can expect to live 17 more years, to age 82.

A 65-year-old woman can expect to live 21 more years, to age 86. For a married couple who are both 65, the wife can expect to live 4 years longer than her husband. This expectation of a woman's not having her husband as a potential caregiver during the time that she will most likely need assistance is one of the reasons that women purchase more LTC insurance policies than men do.

There are limited governmental resources available to pay for LTC, and this is not yet well understood in the marketplace. Medicare pays very little for the cost of LTC. Medicare covers only skilled care, not custodial care. And nursing home confinement must follow a hospital stay. There is a 100-day limit on Medicare coverage, and there are significant co-payments of up to $96 a day required from days 21 to 100, inclusive.

Medicaid is the welfare program for people who are poor and without resources. While qualification standards for Medicaid differ from state to state, you generally have to spend down your assets to a predetermined level before Medicaid will begin to pay. Medicaid pays approximately one-half of the total national expenditures for LTC. About a third of the long-term expenditures are paid out –of pocket by recipients today. These people are typically using their retirement savings to pay for LTC, and many will qualify for Medicaid when their financial resources are sufficiently depleted.

A very small portion of LTC expenditures is currently covered by private insurance, because market penetration is low. Current LTC insurance market penetration is estimated to be between 5% and 7%. For LTC insurance we have a target market that will experience dramatic growth and relatively low current market penetration. And this is not a bad combination if you are looking at entering a new market.

There are different ways to enter the LTC insurance market. You can sell another carrier's plan, or you can develop your own. There are advantages and disadvantages to each. Selling another carrier's plan allows you to quickly enter the market. These products have most likely been filed and approved in a number of states and are ready on the shelf and ready to use. There will be low developmental costs with this kind of entry strategy because most of the groundwork has already been laid.

There is a shorter learning curve involved. The carrier that is currently selling these plans has training and marketing tools readily available. The marketing method for these plans has been tried and proved, and advantages and disadvantages of product design have been tested in the marketplace.

There is relatively low product risk in selling another carrier's plan. Depending on the financial arrangements, there is likely to be only a small amount of financial risk or perhaps virtually none. The administrative support infrastructure is already in place and established. In fact, the administrative support costs are likely to be much lower than if you manufactured your own LTC plan from scratch, because you are going to be spreading the administrative costs over a larger base. These economies of scale will benefit the other carrier and your company.

However, there are some disadvantages in selling another carrier's plan. You have limited product differentiation. Any successful product innovation could be quickly copied by the other carrier, and probably will be. With limited financial risk comes a limited potential reward. Your carrier is most likely to receive some kind of a sales override, and there may be some small sharing of risk, but selling another carrier's plan most likely would have a smaller potential reward than selling your own plan.

Another disadvantage to selling another carrier's plan would depend on the extent to which your distribution system and its system overlap. If the product is similar and the price is similar, there would most likely be no strong reason for a producer to sell your plan as opposed to that of the other carrier.

Another way to enter the LTC market is to develop your own policy. The advantages of developing your own policy include the ability to be innovative in plan design. This is one way to differentiate your product in the marketplace. If you have a successful product innovation, it is still likely to be replicated by your competitors. However, you maintain a competitive advantage for a longer period of time if you don't share your innovation with another carrier in the design stage. When you develop your own product, you are likely to have better control of your distribution channel. Production differentiation and control of your distribution channel could lead to more sales and a higher ROI. There is more financial risk in developing your own LTC policy, but with the higher financial risk comes the potential for higher reward.

There are also some disadvantages in developing your own policy. It is likely to take longer to receive Department of Insurance (DOI) approval on new policy forms than on forms that the DOI has seen before. Developmental cost would be significantly higher if you started from scratch instead of selling another carrier's plan. In addition to developing new products and forms, you would need to deal with the development of an administrative infrastructure or contract for these services with an entity that will be reputable, reliable, and cost-efficient.

There is a significant learning curve for some of these administrative functions, particularly those that relate to claims costs. Underwriting is chief among them. Simply because the company is a good medical underwriter does not necessarily make that company a good LTC insurance underwriter. With long-term insurance you are attempting to manage your risk for chronic conditions resulting from mental impairment or deficiencies in the ability to perform activities of daily living (ADL).

With medical insurance you are attempting to control your risk for acute episodes of health care. While some of the medical underwriting skills can transfer, there is a significant difference in looking for cognitive impairments or physical impairments that could require custodial care over a long period as opposed to conditions that could lead to episodes of acute care.

Claims payment is another area where there can be a steep learning curve in attempting to move from medical to LTC insurance. Mistakes in claims payment as an underwriter can lead to adverse financial results. In the medical insurance world, you are looking to see if the services delivered were medically necessary and covered under the contract. While on the surface it may seem the claims payments would be very similar, initially qualifying an LTC insurance claim for payment is different from determining the validity of a payment for a medical claim. Once an individual is receiving benefits under an LTC contract, payments are likely to continue.

Training or retraining your staff in both administrative and marketing areas is important in manufacturing and selling a profitable LTC product. If you attempt to develop your own product from scratch, you will most likely need to hire either experts or consultants to attempt to move quickly through this learning curve.

One way to limit risk and to deal with some of these disadvantages is through the use of reinsurance for LTC. Reinsurance can facilitate LTC strategy through risk reduction and as a source of information both in the developmental stage and operationally. There are a number of different kinds of reinsurance available. Among them are quota-share, excess, and aggregate. There is also reinsurance for substandard risks and financial reinsurance. I want to introduce the concepts of quota-share, excess, and aggregate reinsurance. The other members of this panel are true experts on reinsurance and will be able to answer your in-depth questions much more capably than I will be able to.

In quota-share reinsurance the risk is shared in proportion to the reinsurance ceded. In a 70/30% relationship, the insurer will retain 70% of the total risk and will cede 30% of the risk for every insured from the first dollar. The reinsurance premium is calculated as the gross premium minus an expense allowance for administrative and marketing expenses, including commissions. The reinsurance premium covers claims and the reinsurer's expenses, and hopefully it leaves a profit margin for the reinsurer. Quota-share reinsurance is valuable for new long-term products with small companies. These companies are concerned with issues such as statutory-surplus strain, insurance-rating agencies, and the risk of a new product line.

Excess reinsurance is used when an insurer wants to protect itself from a particular feature of claims risk. The ceding company is willing to accept risk up to a certain level on an individual, but not more. For those of you with a health background, you can think of this as specific reinsurance. The company may end up paying, for instance, all claims that are under one year in duration and might want to reinsure claims that are over a year.

Sometimes, instead of expressing the reinsurance in terms of days, it is expressed as dollars. Assuming that the benefit is $100 a day, the 1-year benefit that the company might be willing to accept could be $36,500—$100 a day times 365 days in a year. Thus, the company would be responsible for the first $36,500 of any claim, and the reinsurer would cover the excess over that amount.

Using excess reinsurance limits the company's exposure on a particular individual. Thus coverage features, age, duration, and possibly gender determine the premium for excess reinsurance. Large or small insurers can use excess reinsurance, and it can be beneficial if the insurer has a relatively small block of business where the insurer does not have a good spread of risk. This type of reinsurance can also be valuable if the insurer sold a significant amount of unlimited benefit or very high benefit policies where the insurer has concern about long claims.

Aggregate reinsurance protects the carrier from having its claims losses, for all of its policies in any particular year, exceed a certain amount. This amount is called the attachment point, and it is typically stated as a percentage of expected claims. For instance, an insurer may purchase aggregate reinsurance if its claims are more than 150% of expected. The insurer would pay all claims up to the 150% expected level, and the reinsurer would pay claims in excess of that amount.

The premium would be calculated in a manner that is similar to that for excess reinsurance. The premium would be established based on policy features, age, duration, and possibly gender. The cost for aggregate reinsurance is relatively low, because the possibility of a claim being made against the aggregate coverage in any particular year is fairly low. A carrier that is concerned about large adverse shifts from one calendar year to another would choose aggregate reinsurance. This could be a byproduct of new policies being issued or perhaps policies being issued with larger maximums. Reinsurance can facilitate a carrier's LTC strategy through risk reduction, which is the traditional use of reinsurance.

Reinsurance can also be used as a source of information about the LTC insurance market, both during the developmental period and on an ongoing basis thereafter. During product development, a reinsurer can provide guidance on the competitive environment and projected changes in the competitive environment by answering questions such as these:

- Which companies have the hot products? Which don't? And why?
- What features within policies are appealing and selling in the marketplace, and to whom are these policies being sold?
- What competitive design features do you need to be competitive?
- What benefits add additional costs that aren't appreciated by the marketplace?
- Which states are more difficult from a regulatory point of view?
- Are there geographic differences in how products are perceived? For instance, is home care a more accepted form of care delivery in certain areas as opposed to others?
- How should a product be priced?
- What commission schedules are currently being used? What street commission is paid, and what overrides are paid?
- What kind of impact is the Internet expected to have on long-term sales?

A reinsurer has expertise with multiple distribution channels and can help you design a product to fit your distribution channel or perhaps design a product to expand your distribution channels. A reinsurer can also provide or arrange for administrative assistance in areas such as underwriting, claims, policy administration, and field-force training. These types of services enable a carrier new to the LTC market not to have to undergo as steep a learning curve and allow a new carrier in the marketplace to take advantage of knowledge and business practices that have been official in operating a profitable block of business.

A smart carrier learns from its own mistakes. A wise carrier learns from other companies' mistakes. A reinsurer that has been in the marketplace can help you avoid pitfalls that you may otherwise encounter. Reinsurers and their administrative arms have a keen interest in risk selection and in using state-of-the-art underwriting and claims methodologies that have been developed over time.

Our reinsurance relationship can provide information with the initial pricing effort and assistance in spotting emerging trends. This could assist in any repricing activity that could prove necessary. One of the things that an administrative capability affiliated with a reinsurer can do is to give a new carrier economies of scale, in addition to good business practices.

In summary, reinsurance can facilitate LTC strategy both through risk reduction, which is the traditional use of reinsurance, and as a source of information in the developmental stage and operationally thereafter.

Mr. Timothy Edwin Hale: If I went around this room and asked how many people actually own an LTC policy, I'm betting five people would own one. I actually trained as a sales agent when I worked for AMEX Life. I went out and knocked on doors, sat at kitchen tables, and tried to personalize the risk and get potential insureds to understand that they were self-insuring a very large risk.

The excuses were great. My favorite one was, "That is why I smoke cigarettes. I am trying to avoid the nursing home years." We are a whole generation that grew up hoping to die before we got old. Typically, when you are presenting LTC to an insured, the whole goal is to try to personalize the risk. You are trying to admit that this is an unpleasant, unfortunate situation that could possibly happen. And being a reinsurer, I find that is what we end up doing (on a somewhat larger scale) with direct-writing companies.

We have more people over the age of 65 than Canada has in its whole population. And the group over age 65 is growing. These are not new statistics for you, but they help to personalize what is going to happen. The number of Americans over age 85, the "old-old," will continue to grow through 2050. Baby boomers are coming. Here is the bad news. Of those over age 85, almost 50% will be diagnosed with some form of dementia in their lifetime. Sixty percent will require some kind of LTC services. Forty-two percent will require some nursing care in their lifetime. The average stay is still around two-and-one-half years.

When it comes down to a sale, you have to get this comparative risk down to something that people can understand. The probability that you will have a house fire is small, yet everyone has homeowner's fire insurance. Automobile insurance? Got to have it; wouldn't leave home without it. Again, a small average loss. Sixty percent will need some kind of LTC, yet most choose to self-insure this loss. Not only am I trying to sell insurance to individuals, I am trying to sell it to direct companies as well.

I want to be your partner. I don't want to be in a situation where I can make money and you don't, or you can make money and I don't. We want to be partners and share this risk. We can find a level of our risk tolerance. You might want to keep only 20% of this risk; maybe I want 80% of the risk.

Another reinsurance need, as mentioned earlier, is financing. Surplus costs money. Another reinsurance need is capacity. Again, we are talking risk tolerance. I would like a direct company to accept some of the risk. I think if they give a reinsurer

100% of the risk, there is more of a possibility that somebody might not be home keeping an eye on my interest at the direct company. Again, capacity usually refers to life insurance, but I think it is here as well.

One of the risks that I see embedded in the LTC product is the incidence risk, in which you get more claims than you actually expect. Claim continuation risk is where your claims tend to last longer. Persistency risk, as discussed, is very real in a lapse-supported product. The younger the issue ages, the more likely an insured is to have some sort of inflation protection rider and the less likely these people are to lapse their policies.

An interest risk is where your returns are not met. Now I have to admit I am not interested in reinsuring persistency risk. Direct companies can probably manage interest risk better than I could. Again, I am willing to assume some of that risk on a coinsurance-type basis. Really, I think I am looking basically at the other two risks: your incidence and severity claim continuation risk.

We can do individual quota-share, aggregate stop-loss, incidence stop-loss, individual excessive coverage, and individual stop-loss coverage. Traditionally on a coinsurance basis, we usually look at a quota-share type of arrangement. I keep 50%; the direct company keeps 50%. I keep 50% of the reserves; they keep 50% of the reserves. They invest their assets; I invest my assets. That's a great partnership concept.

The extended-wait type of coverage is where I charge a premium as a reinsurer to a direct company. I pay on all claims that exceed a two-year period. If some companies are a little bit less risk tolerant on lifetime risks, they might want to look at something on an excess basis to address that situation.

Modified coinsurance is not as popular, but it is still around. Basically, I accept the risk, but I do not accept the assets. The direct company retains all of the assets and the investment strategy behind those assets. YRT can be based on your actual claim costs. It could be a very small cost in the early years for a direct-writing company.

If you think of the claims costs incurred associated with LTC, they start out very low because of great underwriting and then accelerate exponentially, and the reinsurance premiums are based on that. Usually we would look for a ten-year guarantee period. After ten years, rates and terms could be renewed. There is stop loss that can be done individually or on an aggregate basis. If your total portfolio were to reach a certain level of claim dollars, reinsurance could kick in at that point. On an individual basis it could be a two-year coverage—either a dollar or a time type of coverage.

There are nontraditional products as well. I don't want to be the bearer of bad news, but a lot of companies are looking at alternatives to selling a stand-alone product. As you have heard in a number of panels, discussions, and presentations, there is a sizable investment in selling LTC.

Here is an alternative method that has been invented by one of our subsidiaries. As a reinsurer, I accept 80% or 50% of the LTC risk. I pay, as the reinsurer, the face-to-face assessment at the time of underwriting. This can cost anywhere from $100 to $175. This reduces the issue cost of the direct company. I am accepting that risk, but everybody must pass the face-to-face assessment. If they don't pass the assessment, you are still more than welcome to issue the policy; I am just not going to reinsure that policy.

This can be done on a YRT basis. Again, the reinsurance premiums start out fairly low based on your claim costs. And again, this has to be set up ahead of time, because there has to be some fat in your claim costs—basically that the face-to-face assessment will actually possibly reduce your claim-cost curve, and both of us share in that underwriting face –to face.

This works really well if you own the face-to-face assessment company. It does not work as well if you are just a reinsurer writing checks to a company at $175 a clip. For us in this case, Munich American owns Life Plans, and Life Plans does all of the face-to-face assessments. This turned out to be a very good arrangement for both of us: the reinsurer and the direct company.

Another way to look for reinsurance is on substandard risks. This tends to be the taboo of underwriters, but we certainly don't want to bottom-feed off the declined pool. But as medical technology and more medical advancements continue to develop , risks that were considered uninsurable now possibly could be insured with either limited benefits or through some kind of a reinsurance program. Typically, I do not want to do this as a stand-alone project. I would still like to spread my loss risk and do it over a smaller portion of possibly your individual healthier LTC pool.

Again, the way this would be structured is the reinsurer accepts a portion of the risk on a dollar-quoted share excess-of-time basis. In exchange, I also accept 10-20% of your LTC risk. I think this can be really attractive for some of the employer groups in the multilife cases that people seem to want to be more involved with.

Another possibility is multilife LTC risks. These are usually group products that are guaranteed standard-issue. No underwriting. If you are an employee actively at work full-time 35 hours, whatever the program design can be, you are guaranteed to be issued a policy. Minimum number of lives is required, because the first people to sign up will the ones closest to claim.

Another form would be guaranteed to issue. This is usually a short underwriting form with maybe five questions. Otherwise, you are issued something. If you answer "yes" on any of the questions, you might get a most limited benefit type of program. If you answer "no" to all the questions, you would be allowed to select from whichever plan options the employer or group decided to offer. The reinsurer can accept part of the risk, excess, or quota share.

We're talking now about a claims-only reinsurance product. Buy a claim. Say you have a claim after two years you would like to cede to a reinsurer. Once the reinsurer is going to accept that, the pricing is key, and usually it has something to do with some portion of the actual claim reserve. Again, that is a negotiated basis, but it is a single-premium annuity that the insurance company is buying. In fact, a single-premium substandard annuity is what they are buying. Again, in this case the reinsurer would pay the benefits on a contractual basis for the rest of that claimant's life.

This leads me to substandard-impaired life annuities. Several companies are offering these; some are looking at them. In this case, they are not identified as LTC anything. They are aimed at persons already claim-eligible. This is an agent's best friend. If he or she can't get someone to buy an LTC stand-alone product, he or she can say, "No problem. Just wait until you actually need the benefits and I have another product for you." But it is more expensive.

In this case, we are looking at single premiums to cover mortality and longevity risks—someone who might already be in a nursing home or assisted-living facility (ALF) and has some kind of dementia and could be alive another six years, eight years, or six months. The family doesn't know. Usually the family purchases this type of a product. Pricing is based on a comprehensive assessment. The company will send out someone to do a complete evaluation of the quality and type of care, the location of care, the individual's desire to live, etc.

That is one of the keys to actually pricing this type of a product. Unfortunately, substandard risks must be reserved using standard tables and standard life expectancy, so the surplus strain can be three, four, or five times the actual premium. Passing that along to the reinsurer can help with the surplus. Again, we want the ceding company to participate in this plan. It could be we decide this individual has a risk-life expectancy of 60 months. We can do 50/50 on the first 60 months and then 80/20 on each period after that. Again, everything is negotiable.

Combination products are slowly being introduced, such as combination disability income LTC products for the working-age population. You have a disability product essentially through your working years. Once you turn 65 or retire, it automatically rolls over and becomes an LTC policy. If, while you are working, you unfortunately have an accident or somehow need to access LTC benefits, they can also be accessed.

Critical-illness LTC. We heard Terry Savage talk. We have to give her view a little bit about critical illness. I never thought it would be a big seller in the U.S., but maybe as a combination product, it has a better chance of succeeding.

Stand-alone LTC riders on annuity, health, or life insurance policies. A number of companies are very successful selling these types of products. Accelerated death benefits are intriguing. I've had companies approach me and say, "We would like you to reinsure the acceleration portion of that." The trigger was a nursing home stay of longer than 90 days. That triggers the acceleration. The reinsurer picks up the cost of the nursing home. It was not participating in the mortality of the life insurance policy, but only in the risk of the LTC and an interesting pricing exercise. But actually the charge for the accelerated rider was not going to be enough to cover the charge for the LTC piece. It was not a good partnership product for reinsurance. Now we are talking with them about sharing both the life insurance and the LTC risk.

Guaranteed insurability riders don't seem to be really popular, at least in this country. They are more popular in the U.K. The insured pays some premium throughout the working years to be guaranteed to be issued a policy when he or she is 65. I don't think they are really successful. I don't know anybody who is really selling them with any success. They don't generate a lot of premium, so I don't think their time has come just yet.

In summary, I think one of the big problems in our industry is that LTC is not centrally managed. There is no one place where you can go look for LTC services, LTC expertise, or LTC anything. Although our products are innovative and exciting, they command low sales. We've seen in the last 18 months 3 of the top 10 writers exit the business. LTC is firmly on the government's agenda.

Technology may save or ruin us. Telemedicine is a monitor that you can have in a home that has a stethoscope, a blood-pressure cuff, and a telephone all hooked up to a monitor. You can call up a nurse's station. They can see you, you can talk to them, and they can verify that you have taken your medication and tested your blood pressure. It can save nurses a visit. It could be an incredible product.

On the other hand, I also read an article about new genetic testing that identifies the Alzheimer's gene 30 years before the disease actually shows up. What are the odds that I go and sign up for LTC and go have the test? If it is negative, just lapse the policy in the 30-day free-look period. If it is positive, I keep the policy. As an insurer you are not going to be able to use that test, but your audience certainly will. And again, I want to be a partner with the direct company. I want us both to make money, but if we are going to lose money, we'll both lose money together.

Mr. Jean-Francois Poulin: I really enjoyed Tim's presentation. I like his partner theme. I would second that, except for the part about losing money. I prefer we both make money. I want to talk about examples of financial reinsurance. I think Tim has covered the traditional reinsurance side very well. What I want to do is to go over some of the financial reinsurance transactions that we have done in the past on LTC and how financial reinsurance can help LTC providers become more competitive and profitable.

I want to start with a definition. A lot of people associate financial reinsurance with meaning no risk is transferred. I think it is more that the primary purpose is to help the company with financial issues rather than risk issues. The company is comfortable with the risk it has, but it has this financial issue to deal with. It does not mean that no risk is transferred. With current regulations, it is really hard to construct any reinsurance transaction where you can actually get reserve credit and pass no risk. The regulators made sure that risk was to be transferred.

The problems of financial reinsurance are often unique to the company that is asking for a solution, and they are diversified. It is not a commodity product. There is a lot of back-and-forth between the ceding company and the reinsurer to find the right solution for the problem the ceding company has. And often, the financial reinsurer will deal with the chief financial officer or the corporate area more than the pricing area unless your company is big enough that each individual pricing area is responsible for the capital that it allocates to its line. Again, it is a very unique product in specific situations.

The obvious financial issue is the statutory strain. I think most products produce a statutory strain in the first year. One example is risk-based capital (RBC). There is RBC on premiums and claim reserve, and it is pretty high. In this day and age, with most companies nervous about rating agencies looking at RBC and mutual companies looking at demutualization, it is very important to look at your own RBC ratios and the rating agencies' ratios. RBC is becoming more and more important in ceding companies.

The tax reserve on this product is also an issue. The tax reserve in the early years is much lower than the statutory reserve, which creates some tax costs early on. To compete and have a good ROE is difficult in this market.

And the last issue is the regulations; each state sets its own. There are some states that regulate premium-to-surplus ratios, and there are other regulations in different states that companies may want to deal with. These are all financial issues.

Other things that companies may look at are exiting a market or getting into a market and not wanting to allocate too much capital to the new market. Again, financial reinsurance can help you. I am going to go through a couple of examples of things that we have done in the last few years for companies.

This first example is with a company that had a block business that was fairly substantial but also fairly new, so the business was on average three years old. It had been written over the last three to four years. They had this tax issue, and I am not sure if they had anticipated that the tax problem was going to be this big or if they just wanted to try to get the product more competitive. The difference between the tax reserve and the statutory reserve on the entire block was about 25% of the statutory reserve.

It created a tax gain when the company was still incurring statutory losses. The company wanted to deal with that problem and try to smooth that out over time. Obviously, this tax cost increased the cost of the LTC product. The company wanted to find a solution both for this in-force block of business that it had and also for its new business going forward.

I am going to focus on the solution for the in-force block for the time being. What we proposed to the company was to reinsure the LTC block on a quota-share basis. Basically, we had this offshore company that could take the tax gain. Obviously, what you are looking for is a reinsurer that can take the tax gain and not be affected by it as much as you are. What we did was pay an initial allowance equal to the difference between the statutory reserve and the tax reserve.

That put us in a position that was slightly better than the position that we would have been in if we had had a regular quota-share transaction on this block of business from the beginning. This is because the tax reserve is still higher than what the asset share would have been on that product. We had a slight benefit there in terms of risk reduction.

As financial reinsurers, we are always looking to be in a position that is slightly less risky than the ceding company to give an affordable solution to the problem. In the future, statutory profit on the business will pay back the allowance. All the profit on the business that we reinsure on this quota-share agreement goes back to pay that initial allowance or that difference between the statutory and the tax reserve. Then the ceding company is allowed to recapture after that allowance is paid back. It looks and smells like a typical surplus-relief transaction.

In the beginning of the transaction, we had an initial premium equal to the statutory reserve of $120 million. This position is from the reinsurer's perspective. The reverse would be true for the ceding company. We paid an allowance that was equal to the difference between the statutory reserve and the tax reserve of $33 million. Essentially, it created a statutory loss for us of $33 million.

Then, on an ongoing basis, we got a quota share of the premium and of the investment income and paid our quota share of the expense allowance and of the benefits. As shown in Table 1 in year two there is a small loss that is created mostly from the newer business. This company was growing, so the business written in year one still created enough loss in year two to create an overall loss. Then in year three we have a small gain, and then in year four a significant gain. By the end of year five, I believe the allowance is almost all paid back, and certainly it is by year six.

TABLE 1
FIN RE EXAMPLE 1

	Y1	Y2	Y3	Y4	Y5	Y6
Initial Premium	120,000					
Reinsurer Premiums	—	73,475	72,753	68,776	63,891	60,697
Investment Income	—	8,625	11,779	18,588	21,600	24,136
Total	120,000	82,100	84,352	87,364	85,491	84,833
Initial Allowance	33,000	—				
Expense Allowance	—	21,018	16,845	15,714	14,457	13,300
Benefits	—	7,580	9,925	13,986	15,384	16,923
Total Benefits	33,000	28,598	26,770	29,700	29,841	30,223
Increase in Stat Res	120,000	56,497	53,713	43,334	35,918	31,206
Statutory Profit	(33,000)	(2,995)	3,869	14,330	19,732	23,404

Table 2 shows the balance sheet. You can see the coinsurance reserve under this agreement, as this was done on a combined coinsurance/modified coinsurance basis. The modified coinsurance reserves stayed with the ceding company. The coinsurance reserve is basically the allowance that comes onto my books that is being reduced over time.

TABLE 2
FIN RE EXAMPLE 1
BALANCE SHEET

	Y1	Y2	Y3	Y4	Y5	Y6
Stat Reserve, End Premium	120,000	176,497	230,210	273,544	309,462	340,668
Reinsurer W/H Account-End	86,225	142,721	196,434	252,704	308,088	362,816
Coinsurance Reserve	33,776	33,776	33,776	20,840	1,374	—
Loss Carry Forward	—	3,851	790	0		

Now those numbers don't exactly match up with the numbers in Table 1 if you tried to replicate them. The reason for that is there were some quarterly settlements on this transaction, and that is not shown in these tables. Also, the reinsurance fees were not reflected. But the numbers do add up. As you can see, the coinsurance reserve is reduced to almost zero by the end of year five and certainly paid back by the end of year six.

Now what we have done for the ceding company is defer the problem of this tax reserve to further out in the future. The company obviously has to pay for it, but when the company looked at it from an ROE perspective, this reinsurance transaction increased the ROE tremendously. What we could have done to improve this even further for the ceding company is to have added an experience refund on an ongoing basis to essentially pay the excess profit back to the ceding company so that we would maintain the coinsurance reserve equal to that difference between the tax and the statutory reserve and essentially solve the problem forever for that company.

New business can also enter the program, and again, we have to agree on what the allowance has to be to do that. You can enter it at the end of each year and again base it on the reserve at that point. A 2% fee is what you would see in the marketplace if the ceding company has a good rating and you can put enough risk reduction features in the program.

These risk reduction features would be slightly lower expenses than the ceding company incurs, and there might be some caps also that would be put on claims paid per life and things like that the reinsurer can add to try not to affect the reserve transfer but reduce the risk of the financial reinsurer. This transaction actually lowered the tax cost for the ceding company, reduced its RBC, and tremendously improved its ROE. It was, and still is, fairly happy with this transaction today.

The second example is another company that came to us when one large company exited the market, and this company picked up some of its business. It felt it had unusual growth in this one year and wanted to finance the normal strain that came with that growth and spread that over the next few years. Table 3 shows the typical LTC product. I am hoping some companies will agree with these numbers, but certainly these are the ones we have seen in the marketplace.

TABLE 3
FIN RE EXAMPLE 2

- Company has large unusual growth this year—statutory strain
- Typical product:

Premium	$1000
Commission	($650)
Other Expenses	($150)
UPR	($350)
Claims	($130)
Strain	($280)

You would have a first-year premium of $1,000. Now, 65% would go in commission, 15% would go in other expenses, and 35% in reserves. You would have claims of about 13%, for a strain of 28% at the end of the year. This created a problem, since the company wrote twice as much business as the prior year. The solution was a quota-share transaction, and what it wanted to do was just spread that over the next two or three years.

What we did was a quota-share reinsurance on a portion of its business large enough to make sure that the product would repay, essentially the allowance that we would pay in the first year, fairly quickly. We also made it commit to giving us the next two years of new production. The next two years of production, however, would come at a much lower commission allowance, and that created a profit for us, as opposed to losses.

If in year two and three on new business we reduce our commission allowance to $150, then what we have created is $220 of gain on new policies. That is what we did with this company.

What that did for it was solve this statutory profit issue and defer the allowance over the next couple of years. It spread the statutory strain over the next two years. Again, our fee was 2% of the strain outstanding, and we have implemented an experience refund to spread that out a little further. There is a lot of back-and-forth going into these transactions to try to make those fairly flexible and to adapt to the company's situation. You often see amendments to try to improve the situation going forward based on what the ceding company wants.

I am just quickly going to go over some of the advantages of financial reinsurance. To get RBC relief, the RBC on those products should be 15% of premium and 5% of claim reserve. There is a C1 component associated with the assets. The target of most companies is a certain multiple of that RBC, so premium relief transactions can be done to help the RBC issue. Other advantages include S&P ratios and A.M. Best ratios that can be dealt with by using similar quota-share agreements.

I have talked already about regulatory requirements. Deferring the strain in RBC through a quota-share agreement will improve your ROE. The caveats are that financial reinsurance won't make a nonprofitable product profitable. The pricing needs to be sound. You have to have a good pricing philosophy, and the financial reinsurer should make sure that it likes your pricing before it enters into these transactions. It will improve your financial situation, but if you have a nonprofitable product, it won't change that. You often have to use offshore companies, trusts, and letters of credit.

You have to get familiar with those to get into financial reinsurance. The letters of credit and trusts protect you well, and regulators accept them. Obviously, it costs money to get those transactions done. If you just look at the profit, they will be reduced.

Mr. John Robert Murphy: How do you structure the deal so that when you are doing a tax relief, the IRS doesn't see through it and start looking at tax-avoidance issues?

Mr. Poulin: You obviously have to be careful. I think that what you are looking for is a reinsurer that can take the tax issue. We do those transactions with U.S. taxpayers. And obviously we have some tax laws that we can offset against those, and that is how we are able to handle this problem. Basically, you are ceding your reserve off to somebody, and it becomes someone else's tax problem, usually the reinsurer's tax problem. If the reinsurer can handle it, then I don't think the IRS would have any issue with that.

Mr. Thomas C. Foley: I am one of those regulatory barriers you were talking about earlier. The NAIC is currently looking at the reserve standards for substandard annuities. I am chair of that group, presumably. It is anybody's guess when we will get there, but I think we will get there soon.

I've been working extensively in rate stabilization over the last several years, and I would be interested in any panel member's talking about how we can use reinsurance to help rate stabilization. By rate stabilization, I mean no rate increases ever.

And the second concern I have is about ALFs and a huge bubble that is coming in sales and the public policymakers' insistence that claims be paid. I am wondering if our marketing efforts aren't being so aggressive that ALFs are going to drive us completely out of being able to price LTC products in the near future.

Mr. Newton: I don't see those as actually mutually exclusive. If there are risks in the LTC industry that we have yet to learn, only one of which might be ALFs, then that is something direct writers want to think about carefully before they start really getting more aggressive on rate stabilization.

As a former direct writer of LTC insurance, my personal opinion is I am not terribly interested in noncancelable-style policies, and I wouldn't want to be associated with those from a direct writer's point of view or reinsurer's point of view. If you believe that reinsurers and direct writers are partners and they are going to share in all these risks, I don't personally see how noncancelable policies fit into that picture.

Mr. Foley: Explain to me what you mean by noncancelable. Do you mean actually noncancelable, or the company's having the attitude that it is going to have noncancelable premiums?

Mr. Newton: I mean actually noncancelable. Can't cancel, and can't change rates.

Mr. Foley: I can't foresee that taking place at any point in time. What I am talking about is there are companies that have been in this business for several decades and have never had rate increases and don't appear to have any need to have rate increases. I think there is a way to manage this business so the probability of having rate increases is tremendously reduced.

There are a few maverick companies that seem to have the opposite attitude. Those are the ones that we are trying to change so they are not nearly as motivated to do that. But suppose a company has ten blocks of business. One of them may be a little bit sour. I would be hopeful that either through the ceding company or through reinsurance they can find a way to handle that sour block without having a rate increase. That kind of approach appears noncancelable rather than being specifically noncancelable.

Mr. Newton: I actually agree with everything you said there. Not having to change rates later starts with responsible pricing in the first place. And that is the first line of defense. Products in LTC do get updated on a very regular basis. As far as I know there is not such a thing as a company that has had the same product for ten years and that whole block is at risk for a rate increase. The fact that there are several generations of policies, some of which hopefully are profitable, should be able to offset the risk of one or two of those particular older ones which are most likely to be less profitable.

I would hope that companies would consider reputation issues and brand issues in their decisions about when to file and ask for rate relief.

Mr. Foley: I am delighted to hear you say that, because that is a significantly different attitude than has been prevalent in health insurance for the last 50 years.