



AMERICAN ACADEMY *of* ACTUARIES

To: Mr. Stephen J. Johnson, CPA
Deputy Insurance Commissioner
Insurance Department
Commonwealth of Pennsylvania

From: Mr. Bob Yee, Chair
American Academy of Actuaries¹ Long-Term Care Risk-Based Capital Work Group

Copy: Mr. Philip Barlow
Chair
Life Risk-Based Capital Working Group
National Association of Insurance Commissioners

September 8, 2003

Dear Mr. Johnson,

We received a copy of your letter to Mr. Philip Barlow regarding the Interim Report of the Long Term Care Risk-Based Capital (RBC) Work Group of the Academy of Actuaries. This letter is in response to the comments you made.

We understand your concerns regarding total asset adequacy (here we consider total asset adequacy as statutory reserve plus RBC) as evidenced by cash flow testing sensitivity results and the number and frequency of rate increases. If we understand your position correctly, you asked why lower RBC if the product “is very volatile because of its immature nature.”

We would like to point out that cash flow testing and rate increases are much more related to statutory reserves than RBC. Cash flow testing ignores the cash flow from capital and, therefore, surplus and premium inadequacy may lead to apparent reserve inadequacy under cash flow testing. Rate increases, if administered properly, can mitigate insolvency risks and thereby reduce the RBC requirement. The Work Group followed the precedence set by work groups for other lines of business in examining RBC *separately* from statutory reserves. The intention is to have equitable and consistent methodology across all lines of business. During our investigation, we had numerous

¹ The American Academy of Actuaries is the public policy organization for all actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the actuarial profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

discussions on balancing product consistency and the value of better definition of total asset adequacy for LTC – i.e. one that gives credit for conservative premiums and reserves. (The current and proposed formula, based on the existing model and available approaches, creates higher RBC from higher premium or reserve amounts per \$1 of exposure to claim.)

Our investigation has assumed that reserves are adequate and that premiums are also adequate, or that there is a mechanism in place to adjust premiums to reflect changes in claim costs or trends. We further assumed that insurers are well managed and that the RBC amounts are adequate, at the chosen level of adequacy, to cover statistical fluctuation in experience or delays in implementing needed premium adjustments. To the extent that reserves and/or premiums are inadequate, we assumed that regulatory tools and processes other than RBC would be used to address the inadequacy.

As you know, there are discussions currently at the NAIC level on a new proposal for Long-Term Care valuation standards. The Academy of Actuaries has formed a separate Work Group to assist with the discussions.

We would also note that, prior to the change in the LTC Model Regulation dealing with rate stability, it would have been common for regulators and companies to provide for several increases to avoid one larger one. As such, the prior existence of multiple rate increases for some companies should not necessarily be seen as a sign of mismanagement but, rather, one approach to reducing lapses when rates need to be increased.

We believe our Work Group has performed our analysis in a manner consistent with the generalized model used for all health products per request by the NAIC. Nevertheless, your concerns are well founded to the extent that a particular insolvency is the result of total asset inadequacy. If the Life Risk-Based Capital Working Group wishes us to address the total asset adequacy issue for LTC, we would be happy to do so.

Our Work Group welcomes any further questions or comments you may have.