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THE NEW INCOME REPLACEMENT POLICIES

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1. How do integrated disability benefit plans work?
2. What are the key plan design alternatives?
3. What are the pros and cons in the functional areas of marketing, underwriting, claims, actuarial and regulation?
4. What are sales results and loss experience?
5. What trends are seen for this product?

MR. CHARLES HABECK: Our panel will explore the new income replacement policies that are emerging, and will show how these products depart from those of the past to meet the problems of the present and provide for stable underwriting results in the future.

MR. JOHN C. CATON: What do we mean by income replacement? In the very broad sense, it could mean any form of disability insurance. In the very narrow sense, it could mean only the so-called "no occupation" or pure income replacement policies. However, for our purposes today, income replacement will mean any form of disability policy which provides a monthly benefit which may be affected by any earnings during the claim. This includes residual disability products as well as pure income replacement products.

The most common design is a straight residual disability policy with a partial benefit payable after some period of total disability, which is normally called the qualification period. Benefits are paid if the insured is partially disabled and is earning less than 75% or 80% of his prior earnings.

A common variation allows the partial benefit to be paid immediately without a total disability requirement. This is often called a proportionate disability benefit because the benefit is calculated in proportion to the income lost due to partial disability.

Another variation, though a dangerous one, is the dual definition of disability. This is the best of both worlds. This product combines the traditional residual disability benefit with an "own occupation" definition of total disability.

The last major design is the "no occupation" policy, which pays a monthly benefit provided the insured has a loss of income due to an injury or sickness. He does not have to be totally or partially disabled to collect benefits. The words "disability" and "occupation" do not even appear in the policy. The pure income replacement design is the one with which I am most familiar because my company has been marketing it since 1973.

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About ten years ago, we realized we had become noncompetitive in the individual disability income business, particularly in the professional and executive markets. Although our premium rates were reasonable, our contract provisions had become obsolete. The industry leaders were becoming more and more liberal in their policy provisions. A company could not compete without a long term "own occupation" definition of disability.

We did not want to follow this trend. We did not want to pay benefits to someone who could earn a good living in another job. We asked ourselves how we would insure against this contingency if there were no such thing as disability income business. The answer seemed very clear to us. The loss that the public fears is the loss of income, not the loss of occupation. You do not spend an occupation, you spend the income from that occupation. We began to pursue the concept of pure insurance of income. The result was our income replacement policy.

If the insured has an accident or sickness that causes his income to fall below 80% of his average pre-loss earnings, we will pay a percentage of the maximum monthly benefit based upon the portion of income lost. From this amount is subtracted any benefit received under Social Security, worker's compensation or state cash sickness plans.

There are other methods of calculating monthly benefits under other income replacement type policies. There is a dollar-for-dollar offset of benefits for income lost below the 80% level. One company pays a benefit equal to 80% of lost income below 80% of prior earnings. I know of two companies that reduce their benefit by $1 for each $2 of earnings during a benefit period.

Our original income replacement policy took the dollar-for-dollar offset approach. This is an attractive benefit. However, we abandoned this provision in favor of the proportionate method a year and a half ago when we revised our portfolio. We did this for two reasons. First of all, by 1980, most major writers of disability income had either a residual benefit or some form of income replacement benefit. If one of our old policyholders also had other coverage like this, he would be seriously overinsured in a partial loss situation, thus receiving duplicate payments. The second reason has to do with the overinsurance aspects of the dollar-for-dollar benefit itself. As a claimant returns to work and builds up his income, an after tax dollar is replaced by a before tax dollar. He is not encouraged to work harder until he passes the 80% level.

Income is measured on a cash basis rather than on an earned or accrued basis as found in most income replacement policies. We have found this to be an attractive feature for non-salaried or professional people. It would work equally well in a residual environment. The cash basis is more logical to the insured. Our claimants understand that no benefits are payable with continuing receipt of income even though they may be in the hospital. They value highly the assurance that we will not cut off benefits merely because they return to full-time earnings status if they have not built up their accounts to their prior levels. We continue benefits until income actually received exceeds 80% of pre-loss income. Recognition of income as it is received encourages longer waiting periods; about 75% of our policies sold have waiting periods of 60 days or longer. Our policy also has a carryover provision which deals with extraordinary income received in excess of pre-loss income during the waiting period or benefit period. This income is spread over future months to determine monthly benefits.

We offer two policies. One fully integrates with social insurance plans and represents 95% of our sales. The non-integrated version is used to supplement group long term disability or other integrated coverage. Social insurance benefits are deducted on a dollar-for-dollar basis as opposed to the all-or-nothing basis found in most policies or riders. There is no limit to the deduction. Lump sum payments from social insurance plans are considered income and fall under the carryover provision. We offer a non-cancellable coverage to Classes 1 and 2 and guaranteed renewable coverage to Classes 3 and 4. We offer the standard guaranteed insurability and cost of living benefit riders.

Our experience has been very good ever since we introduced the policy in 1973. Last year, our incurred loss ratio was 50.7%, which was 97% of the expected level. Our cumulative loss ratio for nine years is 48.5%, or 92% of the expected level.

Income replacement coverage is one of our most popular products. The consumer readily appreciates the concept; to him, it is the logical approach to the risk. We have had a more difficult time educating our agents than their prospects. Many agents had to unlearn disability before we could teach them income replacement.

<u>What are some of the advantages of the pure income replacement policy?</u>

1. It provides benefits for loss of income, not loss of occupation; this is what the public really needs. There is no requirement to be totally or partially disabled.

2. It adjusts automatically to shifts in status because there is no definition of disability.

3. Income replacement avoids the irrational risk of own occupation coverage.

4. It provides a partial benefit without a prior requirement for total disability.

5. Recognition of income when actually received provides a perfect fit to the incidence of loss.

6. Income replacement has a built-in rehabilitation benefit because of the incentive to return to work, and that incentive is to return to one's own job.

7. True integration with income and social insurance benefits avoids overinsurance.

8. Income replacement can be designed to lessen the overinsurance risk of early retirement by treating pension benefits as income.

9. Pure income replacement is very saleable; it is a logical and simple approach to the risk.

10. So far, at least, this product has proven to be a profitable one for my company.

<u>There are also certain disadvantages of the pure income replacement policy.</u>

1. Claims administration is more involved due to the requirement for income information.

2. There is a possibility for antiselection because a claimant may have the opportunity to manipulate the timing of his receipt of income. This risk is limited, however.

3. There is a danger of early partial retirement. This is really an unknown quantity at this stage since few owners of income replacement are approaching retirement age.

4. Pricing is more difficult due to a lack of experience on this product. Heavy reliance must be placed on disability data, with modification.

5. Policy language is largely untested in the courts.

6. Income replacement may not be appropriate for lower occupation classes, due to the generally lower work ethic.

7. Pure income replacement is more difficult to teach to agents.

I would like to close my comments on a critical note. In studying the broad spectrum of income replacement contracts, I see many containing features which contradict the concept of insuring income on a sound basis. There are too many examples of policy provisions and practices which can create obvious overinsurance situations. Let me cite some examples.

First, there are several provisions which can lead to situations where the monthly benefit is payable when all or part of it is not needed.

a. Own occupation definition of disability, and the dual definition.

b. Presumptive loss or presumptive disability provisions.

c. Lifetime benefits.

d. Disregard of large income payments received during a claim, such as a deferred commission or a lump sum Social Security payment.

e. Under residual or proportionate disability policies, the assumption of total disability if income falls below 20% or 25% of average earnings.

Second, in the issue rules area, not enough attention is paid to financial underwriting. Unearned income and net worth are important. Issue limits should be lower for two-income families because of the special after-tax effects of a claim by one earner. Also, more attention should be given to proof of income through financial statements and/or income tax returns.

MR. ROBERT G. MEILANDER: In how many states are you approved with that kind of contract?

MR. CATON: We are approved in forty states, I believe. We are not in New England or New York. The only serious problem we have had is in New Jersey. They will not approve the integration feature, and so far they have not approved the policy, either.

MR. W. DUANE KIDWELL: I asked one of our brokers if they have trouble competing with your contract. He said they have no substantial problems. He said just the opposite of what you said. They talk to the client in terms of, "Can you imagine being sick in the hospital for thirty days without receiving payments?" Under your contract, if the income is continually flowing in, there would not be payments. Brokers pick up on that.

MR. CATON: It seems to come down to agent training, because our agents say they have no problem competing with residual or proportionate policies, either. A good salesman picks out his good points and knows his contract. They probably would solve the hospital situation with a waiting period and a good analysis of what waiting period is needed.

MR. GERALD S. PARKER: My job is to examine the external environment, by which we mean chiefly the regulatory/statutory environment and the economic environment. For the most part, the environmental factors will affect any sort of disability insurance, but I will focus as much as I can on the income loss concept.

Let's talk first about the statutory/regulatory environment. In general, this seems to be a little more relaxed than it was a few years ago. Most of the states have adopted their versions of the minimum benefit standards, and the variations are pretty trivial. The Guardian Life filed a new disability series late last year and was able to get approval in fifty-one jurisdictions with only two basic versions. My last new product idea before retiring from The Guardian was a single premium, non-renewable reducing term disability policy that provides benefits from the end of its elimination period to the end of its term. The term can be from one to five years in increments of a month. The idea is to insure large financial obligations of a temporary nature, such as salary contracts and business loans. It carries a $200 non-refundable policy fee to cover policy administration. My staff people were sure I would never get it approved in any of the tough states. They foresaw all sorts of problems. In fact, the only serious problem was in New Jersey.

Disability insurance does not have as many built-in statutory problems as health care expense insurance, because most legislators are not very aware of it, and there is little pressure for mandatory benefit provisions. It is significant that periodically adjustable policies with full direct offset provisions for social insurance have been successfully filed in all but two states. Even more remarkable, Western Life's unique and very imaginative policy has made it through all but about nine states at the last count I had. That policy includes features like a direct offset of <u>all</u> other insurance benefits (social and private, group and individual) and the calculation of a personal replacement ratio for every insured based on four variables and a formula with nineteen steps.

The major stumbling blocks remain, such as New York, New Jersey, some of the New England states and a few of the deep southern states, but the situation is better than it was few years ago.

I know some of you are interested in where New York now stands on the social insurance substitute concept. A New York circular letter is in the final stages of preparation, and it should be out any day. These are the key points.

1. You cannot call it a supplement to Social Security or social insurance, or anything else that implies something in addition to social insurance. Social insurance substitute is acceptable, and that should work everywhere else, too.

2. You cannot include no-fault auto insurance in the definition of social insurance without a fight. The Department's objection to that is that most no-fault laws offset any disability benefits against the overall limit that includes medical expenses.

3. If the renewal conditions of the social insurance substitute (SIS) coverage differ from those of the rest of the policy, such as allowing termination on receipt of retirement benefits under Social Security, each part must have its own renewal provisions. If the SIS coverage is built into the policy, both renewal provisions must be on the face page. If the SIS is a rider, the schedule page of the policy must call attention to the differing renewal conditions of the rider.

4. If you require a claimant to pursue appeals for social insurance benefits, you will have to pick up any expenses of his appeal beyond the reconsideration stage. But you can suspend his benefits until he has applied. You must give him ten days to apply, and then, if he has not proven to you within thirty days that he has applied, you can cut off his benefits until he has applied.

5. Direct offset provisions are prohibited. The Department has not yet approved an indirect offset provision in which the social insurance benefit is counted as current income in determining the amount of the proportionate benefit.

6. New York will not approve a presumptive disability provision on a policy with SIS benefits. Such a provision is inconsistent with a policy that purports to be attempting to prevent overinsurance.

7. The experience reporting requirements will be set forth in detail. However, we were able to pursuade them to show some reason. You can use either a loss ratio method or an actual-to-expected method. Experience may be reported separately for regular benefits and for SIS benefits, or it may be reported separately for policies with and policies without SIS benefits. You have to agree to the data maintenance and data submission requirements to get approval of the form.

There is one rather interesting disability insurance development that does not come under any particular heading. It is the 1979 Florida Wage Loss Law. This was enacted to try to do something about the horrible worker's compensation experience in Florida, much of which seemed to relate to lump sum awards for permanent partial disability. It took effect August 1, 1979. There were only minor changes for permanent total disability and temporary total disability.

But for permanent impairment due to an amputation or blindness (80% loss of vision), there is a cash award of $50 for each 1% of permanent impairment up to the first 50%, and $100 for each 1% above 50%. So the limit is $7,500. For a large lump sum they substituted a wage loss benefit. For a worker who has suffered a permanent impairment, the new benefit is 95% of the difference between 85% of his prior earnings and his current earnings. If an employee could work but refuses to, they can impute earnings to him.

The result of this has been a significant change in claim patterns and a significant reduction in disability claim cost. Medical claim costs have increased, but that may not be related entirely to the changes in the disability patterns. Temporary total disability claims went from 83% of the cases to 97%, and permanent partial disability claims dropped from 16% of the cases to 2%. The average loss of time cost per claim dropped about 9-1/2%. It seems that many of those who are permanently partially disabled can earn enough to work themselves right out of benefits if the economic incentive is there.

Turning to the economic environment, we see real risks for all forms of loss of income insurance, whether disability is required or not. The big risk for all forms of residual disability or pure loss of income coverage is early partial retirement. Are we issuing a retirement income policy for the price of a disability policy?

A big part of this problem is that this risk applies especially to middle-aged policyholders. No company has many of these on these new policies as yet. Few of us <u>will</u> have a significant number for fifteen years or so, given reasonably good rates of sales growth and the kinds of lapse rates that are common in disability insurance. What will the economic climate be at that time?

The economic climate risk is always there for all forms of disability insurance. However, it is especially severe in the relatively untested forms, such as the policies with residual disability provisions, the so-called "dual definition" policies and the pure loss of income policies, in that order.

Economic questions, of course, inevitably lead to Washington, and Washington is where Social Security matters are determined. It seems appropriate to take a look at those and to speculate on where they might be going.

I have to confine myself to the Social Security disability insurance program. We have made some progress there in recent years. The 1977 and 1980 amendments eliminated the double indexing, reduced the unfair difference between the potential benefits of a young disability claimant and an old one, paved the way for tighter claim administration and limited the maximum family benefit to 150% of the primary insurance amount in disability cases. Last year, a "megacap" was added to help with the worker's compensation and other social insurance overlaps.

So what might be next? There are still problems with the disability benefit formula, and they will get worse. For instance, the replacement ratio for a worker whose wages rise more slowly than the average will again exceed 100% before very many more years. Also, is there any real reason why a worker with dependents should get 50% more benefits than one who has none - or only a crippled old wife under age 62?

Last year, The Federal Affairs Subcommittee of the HIAA Disability Committee came up with a different approach to disability insurance benefits. We thought that perhaps the coming crisis in Social Security financing would be so severe that the disability formula could be completely separated from the retirement formula and made rational in its own right. Here is a summary of our ideas.

First, there would be a recency of work test, such as earnings in six of the most recent thirteen quarters.

Second, the average indexed monthly earnings (AIME) would be based on the gross earnings of only the last five years prior to disability, or perhaps the best three of the last six, or some other such formula designed to recognize both the worker whose earnings have been rising rapidly and the worker whose earnings have been declining gradually due to a slow onset of a chronic disease.

Third, the initial benefit would be based on the net after-tax earnings and would provide a replacement ratio ranging from about 90% of net earnings at the minimum wage level, grading down to about 35% at the maximum taxable wage level. Hypothetical net earnings on which to base benefits would be established by applying the actual number of exemptions and the standard deduction to the AIME, regardless of the actual deductions of itemizing taxpayers.

Fourth, dependent benefits would come only from the application of the actual number of exemptions used in determining net income. Specific extra benefits for dependents would be eliminated.

Finally, a "megacap" would be established, ranging from 95% of AIME to 60% of AIME, based on income level. Social Security disability benefits would be the top layer over all other government mandated benefits except veterans' benefits.

Since this plan was developed about a year ago, it has been reviewed and discussed by a number of actuaries and others who are actively involved in this area. The Social Security Administration actuaries, in particular, made helpful suggestions to make it more palatable politically and easier for the Social Security Administration to administer. The idea of starting with net income seems to be a particular difficult point for them to support, and they were very dubious about the political viability of dropping the specific dependents' benefits. The current version of this scheme seeks to accomplish approximately the same replacement ratios by using different and lower breakpoints, a different grading of benefits and much reduced increments of additional benefit for each dependent.

At the end of last year and the beginning of this year, the HIAA staff in Washington was reasonably optimistic about the prospects for these changes. One factor was that Bob Myers had taken them seriously and expressed some support, and he was and is the chief staff technician on the President's National Commission. But the budget impasse has made all of this very uncertain. It is just possible that the need to find every possible dime of savings without impacting present beneficiaries will make something like this attractive.

But it looks now as if the National Commission is the key. No one can foretell what it will really accomplish. If the Commission can only bring in a majority and a minority report, Congress will pay little, if any, attention to it.

Is the income replacement product feasible in the current environment? Assess your risks, protect yourselves as much as you can from known risks and have means in place to spot dangerous trends at the earliest possible stage. Yes, I think disability insurance can be written in this climate, but I am not sure pure income loss can be written in any environment.

MR. KIDWELL: Under the topic of economics, you implied that the success that we might be having fifteen years from now will hinge upon our having a minimum number of policies in force at that time. It seems to be a poor testimonial to our business that our plans for long range success should depend upon our ability to design obsolescence into the contracts.

MR. PARKER: I was implying that I do not feel confident trying to guess what the economic environment will be like then. I was trying to point out that it takes a long time for innovations to come out and tell you what they cost, and we have a great many of them that we are playing with right now. I illustrated this with 150% of Linton A lapses and a 15% growth rate, because this is fairly typical for aggressive companies right now. This shows how long it takes to get a significant amount of seasoned business to develop these claims. But the real point that I wanted to make was that you may have an economic environment that cuts your sales, such as a change in the size of your prospect list. In fifteen years, there will not be as many people at ages 35 to 45 to buy our products. But there will be proportionately more people at ages 50 to 55 that have been on the books for ten to fifteen years. So instead of having 12% of seasoned business on your books at ages 50 and over, you might have 25% of it at ages 50 and over. If you have made some serious mistakes on your coverage, that will hurt.

MR. DAVID L. BAXTER: I have been asked to talk about the marketing ramifications of these new income replacement products. I will be speaking from the perspective of a company which has been looking at these products for many years, but which has not yet made a decision to get into them. That does not make any less valid the points I have to make today. Our decision not to enter into these products is heavily dependent on our own particular company and on our own market strengths.

What do I mean by the marketing of disability insurance? On a rough basis, marketing of this product is a negotiation process between the customer and the company. The customer wants all of the insurance he can get at a low price, and insurance that will pay almost any time he wants to ask for it. On the other hand, the company would like to see a product that will not create a high amount of overinsurance, and also a product whose definition of disability is objective enough so that payment of benefits is not just up to the client. The whole issue boils down to two elements. How much does the client collect? When can he collect it? Almost every issue that has ever emerged from the disability line boils down to these two questions.

From the client's evaluation of the product as far as benefit amount, he wants "enough", whatever that means. Some clients say they ought to have more than they were making before as compensation for being in such rough shape. Others may accept the concept that they really only need somewhat less. But whatever it means, they certainly want "enough" as they define it. And they want this to be paid for almost any disability that could arise.

From the company's perspective on amount and contingencies, it is looking for a product to be priceable. By priceable, I mean controllable and measurable. The amount is not too great to encourage malingering, and the definition of disability is objective enough that morbidity levels are determined by the whims of sickness and accident, but not by the whims of the policyholders. Any new disability income concept can be evaluated using these criteria. Does it do a better job of meeting the company's needs as far as avoiding overinsurance, antiselection or abuse?

Let us look briefly at the "own occupation" question and some of our company's recent findings. As many as 35% of our claimants are paid under an own occupation definition, so by what has been said here, as many as 35% of our claimants may be receiving too much in benefits. Of those, about half are working at something else. Now, does the client need this? In our markets, which are primarily professionals and fairly highly compensated executives, the clients think they need it. So from a marketing perspective, this fact alone makes it difficult to buck the trend.

In all of these design controversies, we are talking about the fringes and gray areas. If we look at an income product or a residual product, all contracts are going to pay about the same for most claims. If the person becomes disabled, the policy pays some function of what he purchased. I am not saying this is not important in marketing. For the client, it is certainly very important; he wants full protection. From the company's perspective, those little gray areas are the areas of possible abuse. They can add substantially to the cost, so it is important to address them. The key to a successful disability business is narrowing the gray area for better assurances for the client and better assurances for the company.

Now I will turn to a product feature that may be the most important in the disability market right now, and that is convenience. Convenience in this business boils down to the question of whether the agent will sell it. Income replacement is a difficult concept for agents. They do not have enough time to spend learning about the product. So there is a tendency for the agent to stick with what he knows best.

These are the considerations that led us to conclude that the marketing difficulties of this product are too great for our company in our markets. There are some situations where this product is a good idea. First, in the lower income market, the Social Security offset becomes significant relative to the overall income that the claimant is receiving. If a client is earning $100,000 or more a year, we are able to wink a bit at an extra $200 a month. It is tough to do that with someone who is earning $800 a month. So in that market, it may be essential to have a Social Security offset.

Second, if you are starting with an agency force that has little experience in disability selling, then you do not have the problem of overcoming traditional thinking and sales approaches.

Third, a market that is relatively uneducated in disability insurance does not have preconceived ideas about what to expect, so these new products are easier to explain. To the extent that clients identify disability insurance with an occupational sort of definition, you have to overcome that strong inertia of pulling them away from that.

One final consideration involves the use of an accumulated data base. Our company has disability data based on products having occupational definitions of disability. Managing this business demands access to good data. If we were to develop new products under a totally different concept, we would be losing the use of a valuable asset.

MR. CATON: I would like to ask Dave a question. You say you considered a companion income replacement product. I wondered if you considered a hybrid like a zero day qualification period.

MR. BAXTER: I think our product is pretty close to a hybrid right now with the residual rider. Soon we will have a proportionate residual, which we call a first day residual. I think that puts us pretty much there. Both concepts are going to cover most claims the same.

MR. KIDWELL: Many of us have been lobbying for a true loss of income policy for several years. We have been envious of American United Life for having the foresight to develop the product and the confidence to try it out. We now have our own version of the lost income feature in the policies we are calling residual contracts. These are one step short of pure loss of income policies; we feel the need to stay a step ahead in claim control by hanging onto a firm definition of disablement.

Judging from current high rates of sales growth, these residual policies are highly endorsed by the agents and consumers, and that final step to eliminate the definition of a physical disability may not be necessary. I would not want to lose this added protection against a deliberate partial early retirement. These lost income policies do not make the objective determination of disablement or recovery any easier, but they do add a dimension of control on benefit entitlement. They are more closely fitted to our purpose of replacing the actual spendable income that has been lost due to a sickness or an accident. This added dimension changes the measure of the morbidity factor from "on" or "off" to a dynamic measure with infinitely many degrees of "on" and "off". These policies require methods of measurement in underwriting and claims handling that are more precise and yet more fluid than for fixed benefit policies, and they require more responsive monitoring since we are working with unproven features.

We all know that overinsurance, whether obtained deliberately or by speculation, leads to antiselection. The payment of partial benefits provides many more opportunities for abuse. Overinsurance often does not show up until claim time, when the claimant is often pleasantly surprised at the large amount he is receiving in benefits and the small amount he really needs. Even though his initial purchase is well within the maximum schedule, he can easily become overinsured (even to the extent of exceeding his predisability gross income) from such sources as:

a. future income options.
b. unearned income from investments or inheritance.
c. workers' compensation, salary continuation or social insurance.

d. no-fault auto coverage.
e. insurance with other companies.
f. larger benefits for accident coverage.
g. retirement benefits.
h. spousal income.
i. larger benefits because premiums were paid annually.
j. larger benefits permitted for employer pay.
k. cost-of-living and indexing.
l. opportunity to adjust expenses.
m. reduction in living needs.

Aware of these possibilities, underwriters are faced with providing adequate coverage without subjecting the compar-- to exposure greater than was anticipated in the pricing. They try to do this by making sure an insurance program always has a significant degree of coinsurance or risk sharing.

Participation limits are usually set so that the insured will carry 20-25% of the loss at the lower end of the income scale and perhaps as much as 70% or more of the income loss at the higher end. There is constant pressure from the field to increase the replacement ratio. Up to now, we have been quite successful in holding the line. Even so, this is a losing situation as other sources and amounts of disability income continue to grow.

Coinsurance is harder to control for true income policies, because the significance of the lost income to total earnings decreases with partial benefits. Thus the degree of coverage can vary from month to month during the duration of a disability, not just at issue or at the beginning or end of a claim. To further complicate the underwriter's task, we have added prior income indexing and cost-of-living increases. Although indexing and cost-of-living keep benefits updated after disability, we permit insureds to keep the amount of pre-disablement coverage up to date by periodically submitting evidence of increased earnings. These products do a fine job in the automatic programming of the consumer's needs, and we hope they will improve persistency by reducing the need for agent activity.

We must be very careful at issue and at the time of any updating to be sure that the declared income does exist, is predictable and will always be significant to the financial maintenance of the family. We must have a clear understanding with salesmen and insureds that the sources of income disclosed at the outset will play a major part in determining the sources of income used to measure the income lost during any disablement. The burden is on us to be sure that both the agent and the insured are fully aware of, and in agreement with us on, the types of income that are covered.

Our usual sources of earned income information are the application, supplementary income statement, agent's report, inspection reports, accounting statements and tax forms. They are still available, but they are now being used to document more precise information. Until recently, the applicant was required only to agree that he earned at least the amount required to support the benefit for which he was applying. Most companies used this approach. It made life easier for the agent and the applicant. Unfortunately, it did not provide us with data on experience by degree of coverage. Yet the degree of coverage is our primary concern.

Many companies now make broad use of home office phone call interviews with applicants and report that the financial information thus obtained is willingly stated and highly reliable. Basic financial underwriting is about 90% factual: collecting the numbers, reading them and relating them to appropriate tables of income. The real expertise is needed in the other 10% or so, the larger cases that require interpretation of the numbers and the application of a lot of common sense and insight in putting the pieces together. Underwriters must develop a feel for, and become comfortable working with, the very large incomes claimed by some professional people. They must develop a sense for reasonable relationships of expenses and taxes to gross income and what might justify deviations from the published tables. We must use our own accountants for training underwriters and for consultation in appraising the consistency of financial numbers. Also, we must encourage the use of Certified Public Accountants from public practice to broaden our training and keep us up to date.

Applicants request larger amounts as inflation builds the need, competition builds awareness, longer elimination periods and high interest rates reduce the cost per unit and business factors make large benefits affordable. Underwriters can now feel that the amounts are so significant and the consequences so great that we can well afford the added cost of thorough financial underwriting. Payments on one bad claim can easily wipe out the profits of more than two hundred equivalent ongoing policies.

Benefit clauses of some policies being sold today provide for a reduction of payments if the disability income from all sources would exceed a stated percentage of the insured's predisability income. Technically, this should be a comfort to the underwriter as well as to the claims examiner. As a practical matter, the agent, and possibly the consumer, would find it a sales negative. It is a feature that I wish were in more prevalent use in private insurance. If the private sector does not agree, it should certainly be considered for social schemes to help keep overinsurance from abusing both sectors.

Claims handling on our true loss of income policies is even more heavily impacted than underwriting. As usual, we must substantiate the disability, but now we must also define and measure the proportion of lost net earned income every single month in order to calculate the amount of benefit. Not only is the expense of handling going up, but also we are concerned that time service will deteriorate while financial information is being gathered and evaluated. The majority of cases are still for total disability at the outset, and on these we can continue to provide prompt service. A growing number of policies, however, are being issued with zero day qualification periods, and on these, the full financial impact must be determined at the outset. In order to give the best possible time service, the full amount will usually be paid, subject to audit and later adjustment, if necessary.

Insureds are even more cooperative at claim time than at issue, because the benefits are more tangible. The sources of information available are essentially the same as at issue, including the statements of the claimant or his bookkeeper, tax forms, inspection reports and, again, home office telephone counseling interviews. Telephone interviews not only speed up the initial processing of a claim, but also provide an opportunity for us to clear up any concerns the insured might have, and to set the stage for continued cooperation throughout disability. We advise the insured that routine audits will be required from time to time and that they will be conducted so as not to interfere with the normal payment of benefits on schedule. Claimants are very understanding of our needs and are very willing to cooperate.

Claims examiners are being trained in the economics of incomes. Often the amounts involved are substantial, and a comfortable feeling for dealing with these large numbers must be developed. We need to be able to assure ourselves that the proportion of income lost is commensurate with our judgment of the degree of disablement. We must understand how these numbers vary by occupation, and we must judge that the business expenses being claimed are reasonable and consistent with expenses disclosed in the initial application. If we must audit a claimant's books, we need to know what to look for and where to look. There is a growing need for the training of accountants as claims people, not only for counsel and training of others, but also to perform these field audits.

Insurance policies usually define earned income as the basis for insurance, even though most of us operate on a cash basis. The confusing part is the timing between service rendered and the corresponding income received. At underwriting, we ask for earned income in terms of spendable income received during a calendar year. For insurance purposes, it is more logical to measure the income associated directly with efforts that were expended during a period of disability. For a salaried person, this is well defined; for a professional person, the income may continue to flow for a month or two after he has become totally disabled, and may not reappear in full for several months after he returns to full activity. Furthermore, actual cash flow for a one person business is not smooth from month to month, and even running three-month averages bounce around. To overcome this, we may find it necessary to provide the insured with the best of both worlds, looking at the degree of disablement at the outset and the cash flow at the end. In between, we would tend to pay as applied for, if reasonable, and to adjust later. The insurance is only for that portion of the lost net spendable income that was initially insured, and we try to match that in aggregate over the duration of a claim.

In auditing, we can review appointment records, job invoices and records of payment. We also have access to surveillance of activities in the very rare case where there is evidence of a serious inconsistency. We must frequently audit, because we need to assure ourselves that net earned income is not being manipulated by padding expenses, delaying billings or heaping taxes and rent.

Claimants often consider themselves partially disabled for insurance purposes as long as they are having post-illness checkups. This attitude can stretch out a benefit period for several months or even support an early retirement, neither of which is contemplated in the pricing.

We cannot overemphasize the point that overinsurance is not necessarily a result of deliberate action at issue. It frequently arises during a claim when the insured has the opportunity to influence the amount of benefit he will receive and to weigh the value of returning to work. The need to stay alert and to develop standard procedures for auditing is very clear.

Pricing for lost income benefits involves not only the usual elements of rates of disablement and rates of recovery, but also the elements of partial disablement. The majority of claimants will still be either fully disabled or fully active. Nevertheless, we must find a basis for estimating the amount of additional benefits paid out as partial benefits, as well as to value the amount being saved by the graded recovery feature. The presence of partial benefits should encourage natural rehabilitation and should result in shorter periods of total disability in many cases. Any pricing method must recognize the higher administrative expense. Some actuaries simply add the premium for a one or two year 50% partial disability benefit, with which we are already familiar. Others add 5% or 10%, grading by age, to the rates of disablement and reduce the rates of recovery by similar amounts. Another approach is to apply a factor, grading by age, to the claim cost, or to broadly judge the proportion of the total monthly indemnity expected to be paid as partial benefits. Whatever approach is used, it is evident that there is a wide range of opinion.

Tables of morbidity contingencies are scarce. They are not current, and not one of them can be said to directly represent the business any one of us sells. Therefore, most companies have attempted to build their own pricing tables starting with rather crude loss ratios and graduating by the 1964 Commissioners Disability Table. These have proven to be acceptable for grading by age and class purposes, and adequate because of multipliers and trend factors reflected throughout the rating formulae.

There is strong evidence of antiselection by size of indemnity. While we have not been able to correlate this with other parameters, it bears consideration in pricing. Our company's most recent experience is shown in this table.

1st Year of Benefit Claim Cost Index by Amount and (Count)
Disablements of 1978 and 1979 - Paul Revere
All Years of Issue

<table>
<tr><th>Monthly</th><th colspan="3">Class 4A</th><th colspan="3">Class 3A</th></tr>
<tr><th>Indemnity</th><th>Incidence</th><th>Recovery</th><th>Claim Cost</th><th>Incidence</th><th>Recovery</th><th>Claim Cost</th></tr>
<tr><td><$500</td><td>100(100)</td><td>100(100)</td><td>100(100)</td><td>100(100)</td><td>100(100)</td><td>100(100)</td></tr>
<tr><td>$501-$999</td><td>110(112)</td><td>110(115)</td><td>121(127)</td><td>124(125)</td><td>123(122)</td><td>152(153)</td></tr>
<tr><td>$1000-$1999</td><td>129(131)</td><td>128(131)</td><td>165(172)</td><td rowspan="2">160(172)</td><td rowspan="2">151(155)</td><td rowspan="2">241(270)</td></tr>
<tr><td>$2000 or higher</td><td>147(142)</td><td>147(142)</td><td>168(172)</td></tr>
</table>

Although data by replacement ratio would be more useful, it will be two or three years until it can be accumulated. In the meantime, we need to charge more equitably for the extra expected morbidity of the larger cases. This can be done rather easily either by using smaller policy fees or by allowing discounts that vary by the degree of coinsurance the insured is willing to accept. In simple form, the degree of coinsurance could be a factor to apply to the amount otherwise payable as lost income. In a more complete situation, the policy could provide full coordination of benefits from all sources with a coinsurance factor to apply to the total lost income. Regardless of the approach taken and the final factors used, constant monitoring with quick reaction is the vital role.

MR. GARY L. CORLISS: My question is for the others on the panel, because of what Duane mentioned about the large amount policy sizes. Would you care to comment on the experience with which you are familiar for larger size policies?

MR. BAXTER: Our experience shows a definite trend towards worse results under larger policies. This is true in $500 intervals from $500 right up to $4,500.

MR. PARKER: As of the time I retired, Guardian had done only one study on this, and it was not a very complete one. At that time, there was no evidence that the large policies were significantly worse than the small ones. However, I should emphasize the necessity for very careful financial underwriting on the big cases, which Guardian has always followed.

MR. DONALD A. SKOKAN: Duane, can you give us some information about where the new reserve table for disability insurance stands right now?

MR. KIDWELL: Yes, the termination rates of the new table are on my desk. They are being checked for consistency. The rates of termination are in weekly form with modifying factors by sex, accident versus sickness, occupation class and elimination period. The factors tend to disappear with the longer durations. The current form is weekly termination from disablement rates for the first thirteen weeks, then monthly rates for three months, followed by quarterly rates for the balance of two years and then annual rates. The next process is to determine what sort of margin should be added, if any. The termination rates will then be circulated to members of the committee for comments and suggestions. We are on the program for the Washington annual meeting, so hopefully, there will be something very close to a final report by that time. We broadened our scope to include incidence rates as well. We do not yet have the incidence rates, but hopefully, they will be done by the first of September.

MR. SKOKAN: My second question also deals with reserves. Will you give us some ideas on how one might go about reserving for a residual benefit?

MR. KIDWELL: We use a very practical approach, because we do not have good data. We do know how we built our premiums and we know that the premium differentials on our residual versus a comparable non-residual are about 10%-11%. So we simply increase the active life reserve factors for the other product by 10%, to determine active life reserve factors for the residual policy. Turning to the claim part with respect to the residual, we set up a reserve equal to the disabled life reserve for the last payment made. That is conservative because, on partial, the amount should decrease as a person recovers progressively. On the other hand, it is deficient in that it does not reflect that there might be an additional two or three months paid on each claim. Perhaps there is a balance between the two. We do not reserve additionally for the cost-of-living or the indexing features. We feel comfortable because we are statutorially reserving at only 3-1/2%. If we ever change that reserve to a higher interest rate, then we must look at those two features as well.

MR. SKOKAN: Have you had any trouble with those methods as far as having the reserves justified for Internal Revenue Service purposes?

MR. KIDWELL: No, we have had no problem with them at all. The active life reserve is a function of the relationship between the two gross premiums, which has proven to be perfectly acceptable. We have not had any trouble with the claim reserves, either, even though we feel that our reserves are conservative because of the interest rate.

MR. PAUL E. COONEY: I have a question that I would like to address to all of the panelists. Where are we today with leapfrogging in lifetime benefits, income and participation limits, zero day qualification periods and premium rates?

MR. KIDWELL: We are perilously close to another temporary disaster. We could develop a repeat of the experience of 1974 and 1975. That would restore some semblance of sanity. There is a tremendous amount of leap-frogging going on, with companies getting into the business primarily to support their field forces. Disability income looks like a good way to generate expense money. Some companies are coming in recklessly, even towards pushing sounder operations into questionable practices on amounts, underwriting and insuring clauses.

MR. PARKER: I would say that the price situation is not quite as bad as it was a few years ago. I think people got burned in 1976, so the rate cutting stopped about then. But everything else has gone haywire.

MR. KIDWELL: The actuaries should have stepped out front a lot sooner. Actuaries have recently been influential in improving the underwriting situation, particularly the financial underwriting, and the claims handling, but they have been less effective in the design of sound products of a long range nature.

MR. CATON: I view it as a segregated basket of products. The larger writers, the more responsible and sophisticated writers, have not gone off the deep end as they might have done ten years ago. But there definitely are some companies coming out with products by picking good features from many products and trying to put them all together. A few of them might get hurt.

MR. BAXTER: I agree with that, Jack. There are just so many variances in underwriting, benefit practices and markets, that it is never safe to simply copy another company.

MR. COONEY: I would like to add that perhaps we are feeling some fallout from sales in life insurance activity, especially with the high commission dollars, that may be bringing on the intensity of competition that we are seeing in the health area.

MR. SKOKAN: With regard to an integrated policy which has a renewal provision beyond age 65, is it possible to integrate with Social Security retirement benefits at that point?

MR. CATON: Our policy does it in a subtle way. We simply say that it integrates with any Social Security benefits, and we interpret that to mean retirement as well as disability.

MR. PARKER: The Guardian's social insurance substitute coverages define social insurance to include the Social Security retirement benefits.

MR. HABECK: If you have a zero day qualification period for the residual benefit, what is the difference between that and the kind of policy that American United is selling? Is that the same thing?

MR. CATON: They are very close, but you still have to be disabled partially or totally on a proportionate policy. That is significant. I do not know of a disability rider that uses a cash basis. It is a very significant feature in our policy.

MR. HABECK: What changes do you see for your own products in the future? Do you see things in that policy that the advent of this type of income replacement would call into question? Do you see anything that we should provide for in a revised product?

MR. PARKER: We are going to see more development of the flexible or adjustable benefit policies which are reunderwritten periodically as to the amounts. Also, we are going to see joint disability policies for working couples. The latest information I have is that well over 50% of married couples are both working now. I recently did some work on the effect of the dual income on the replacement ratios, and it is quite frightening. Just to comment on the question of the residual approach with no qualification period versus the pure income loss, I should point out that not all residual disability provisions require disability. If you have no qualification period, there would not be any essential difference.

MR. PAUL E. HANSEN: Everything I have heard so far has been an adjustment from what was done in the past. We are making it more complicated for our agents, for our underwriting staff and our claims people. Complications mean expense. At what point in time does this particular policy become too expensive to keep on our books? Will that ever happen?

MR. KIDWELL: Our loss of income policies are doing a reasonably good job and they are constantly being improved. Unfortunately, every innovation seems to add complexity and frustration to company administration. Perhaps someday we can modify the contestability law that has no useful purpose in disability income and develop a very basic policy that will simply pay me what I need when I am sick or hurt.

MR. PARKER: Mr. Hansen's question brings up a good point which worries me a bit. Most of these policies we have been discussing can only be sold in fairly large units. A company cannot afford to sell them in a blue collar market at a $150 annual premium. Also, they require sophisticated computer programs to be administered effectively. Unless someone makes the necessary software available to everyone, only the larger companies will be able to be in this market.

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The attached materials were distributed at the session. The main concepts for income insurance are set forth in the chart; the condensed reading list contains a variety of reference materials on this topic.

CONCEPT CHART FOR INCOME INSURANCE

1 THE STATUS DEFINITION OF "LOSS"	2 RESIDUAL INCOME LOSS	3 "PURE" INCOME LOSS	4 INFLATION	5 SIS RIDER (OR POLICY)	6 WHO PAYS PREMIUM?
7 PRESUMPTIVE DEFINITIONS OF LOSS	8 E.P. & Q.P. WHAT IS 0-DAY Q.P.?	9 NON-CAN? G.R.? S.R.O.?	10 GUARANTEED ISSUE OPTIONS	11 SI BENEFIT "FREEZE"	12 UNEARNED INCOME
13 OWN OCC PURE OR MODIFIED	14 PROPORTIONATE LOSS CONCEPTS	15 MIN/MAX INCOME LOSSES	16 BASES FOR INDEXED BENEFITS	17 OFFSETS: SSDI, WC, SCS AUTO NO-FAULT CIVIL SERVICE	18 REPLACEMENT RATIO SCALES BY CLASS
19 BENEFIT PERIODS	20 RISK OF EARLY RETIREMENT	21 SEQUENTIAL PARTIAL/TOTAL LOSSES	22 WHAT IS INCOME? CASH/ACCRUAL	23 SOC SEC DI PRIMARY OR FAMILY?	24 TAX IMPACTS FEDERAL STATE, FICA
25 B.O.E. ANY CONFLICT?	26 REHABILITATION AND TRIAL WORK	27 PREMIUM WAIVER	28 PROOFS OF LOSS	29 ALL OR NOTHING DOLLAR FOR DOLLAR (MINIMUM?)	30 TWO-INCOME FAMILIES
31 FLORIDA WAGE LOSS	32 NEEDS CHART: TEMP/PERM TOTAL/PARTIAL	33 PREMIUMS: LEVEL OR ATTAINED AGE	34 LUMP SUM INCOME	35 WHAT IF SI CHANGES?	36 OTHER COVERAGE

"THE NEW INCOME REPLACEMENT POLICIES"

Reading List

[1] Caton, John C., "The Income Replacement Policy After Six Years." The Health Insurance Underwriter (September, 1979), page 13.

A review of AUL's product development and results, including agents' reactions. Includes pros & cons, market limitations.

[2] Hamner, John, "Pure Income Replacement--A Concept Whose Time Has Come." Best's Review L/H 80 (November, 1979), page 30.

Marketing enthusiasm comes through in this article; reactions to it are found in Best's Review for February, 1980.

[3] Hamner, John B., "Individual Markets--Income Replacement." The Health Insurance Underwriter (March, 1981), page 1.

An informative discussion with lots of facts.

[4] Herrick, Kenneth W., Total Disability Provisions in Life Insurance Contracts. Richard D. Irwin, Homewood, Illinois 1956.

Contains valuable background information. Supports "pro-rate" clause to achieve principle of indemnity (clause sets top replacement ratio).

[5] Miller, David J., "Why a New Disability Portfolio?" The Health Insurance Underwriter (January, 1981), page 1.

Discusses Lincoln National product. Author foresees addition of residual benefit to adapt Flex-Pro to professional markets.

[6] Miller, John Haynes, various items from Disability Newsletter:

DN-3 (April, 1975): "A Critique of the Residual Disability Benefit" by Mr Miller. Thorough treatment but some misgivings as to risks.

DN-5 (August, 1975): Reply to previous item by E. Paul Barnhart. Residual approach seen as an improvement, in any case.

DN-10 (October, 1976): "The Market for Disability Income Insurance: How Much Is Left?" Mr Miller poses a pertinent question.

DN-15 (November, 1977): "The Future of Non-Can Disability." Some doubts emerge as to viability of guaranteed premium coverages.

DN-17 (May, 1978): "Long-Term Disability Insurance Problems Still in Evolution," by Eduard H. Minor, FSA.

DN-22 (December, 1979): "Guaranteed Renewable vs Non-Cancellable Disability Insurance." Comments by Ben Helphand and Gerald S. Parker.

DN-24 (April, 1980): "The Metamorphosis of the Individual Disability Policy Contract." Valuable summary of Lincoln National's Flexible Income Protection Policy, with comments on non-can "Pro-Add."

DN-26 (August, 1980): "Filling the Social Security Gaps, Centennial's Solution." Covers various aspects of contingent benefit provisions.

DN-27 (January, 1981): "Trends in Disability Definition." A fairly broad survey of various plan design alternatives.

[7] Miller, John Haynes, "Disability Insurance, An Assessment of Its Social Value." CLU Journal 32 (July, 1978), page 12.

Some important basic concepts are explored, as well as influences on disability continuance, such as replacement ratio, taxes, social security and rehabilitation programs. On page 24 Mr Miller recommends renewable term coverage with guaranteed insurability, an approach that may be gaining favor in some markets.

[8] Parker, Gerald S., "Disability Insurance in the 1980's--Friend or Foe?" The Health Insurance Underwriter (March, 1980), page 1.

Text of a talk for LIMRA seminar of December 12, 1979. Cites past practices, lack of foresight; changes in external environment; regulatory impacts; overinsurance, especially in dual income families.

[9] Sluyter, Robert N., "One More View of Residual Disability Income." Life Association News 76 (March, 1981), page 121.

This article follows one by Allan Checkoway, who adds his comments.

[10] Soule, Charles E., "Disability Income Insurance in the Eighties." CLU Journal 36 (January, 1982), page 42.

Comprehensive review of changes over the years, with his list of predicted product changes for this decade, some of which we now have.

[11] "Analysis of Workers' Compensation Laws." New edition published yearly by Chamber of Commerce of the United States.

A valuable reference. To order, write to the Chamber at 1615 H St., N.W., Washington, D.C. 20062; or call direct 301/468-5128.

[12] "Compensation Systems Available to Disabled Persons in the United States." A report of the research subcommittee of the Disability Insurance Committee of the Health Insurance Association of America, 1979.

Lists and describes various systems now available, and gives examples of how benefits are paid, over- and under-insurance, etc. Write to the Health Insurance Institute, 1850 K Street, N.W., Washington D.C. 20006.