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INDIVIDUAL DISABILITY INCOME CONTRACT PROVISIONS

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. Has competition resulted in unsound contract provisions and/or underwriting rules?

- Definition of disability
- Occupational definitions
- Social insurance offsets/replacement ratios
- Other provisions/underwriting rules

. Trends in product design and underwriting

MR. CHARLES HABECK: The history of disability income insurance can be characterized using words like cyclical, reactive, and tentative. Such a history is not susceptible in any discernable single line of development. In fact, the main threads intertwine along the way and now one may see some signs of regression, or if you want to use the libelous term, "backsliding".

The forces affecting the various product developments and changes can be grouped under several headings:

1. Marketing considerations. This includes market segmentation of which we are now seeing a considerable amount.
2. Regulatory requirements.
3. Judicial pronouncements have indicated to us what various contract provisions mean.
4. Economic considerations. We see this impact most pronounced during periods of recession.
5. Actuarial considerations. These are theoretical principles, basic actuarial or underwriting principles.

Among these five main forces, or types of forces, the most powerful seems to be the marketing consideration. I think this has been true all the way along. There is no doubt in my mind at least, that the success or failure of a product will depend on its marketability. What this means for us is that if actuaries and underwriters are to have any influence on the design and pricing of income insurance products, they must be concerned with the

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marketing aspects of the products they design to price. A consensus or a compromise must be reached with the insurers marketing arm. This cannot always be done and we get into some extreme situations:

1. Where the product is properly designed according to the actuarial viewpoint, but it simply cannot be sold.

2. Where a product runs away with the market and may bring disaster to the insurer in the form of some kind of anticipated risk.

Throughout the history of disability income, the greatest risk that seems to have emerged is that of overinsurance. The HIAA study that was published in 1979 brings out a number of situations where overinsurance occurred. In fact, that study includes examples of underinsurance. I believe it was that study more than anything else that led to the desire to get a better fit of benefits to the actual loss that occurs. So, overinsurance can occur in any situation where the benefits do not correspond to this loss and in fact benefits exceed the loss.

Along with this concept of overinsurance there is a concept of inequity among the policyholders. The inequity will occur and probably will not be recognized by them unless they are buying the plan for the same speculative reasons that the benefits from these liberal provisions had in mind. A balanced effort is needed to properly market and manage disability income benefits.

As a convenient means of presenting the main concepts that have been involved in the development process, I distributed sheets which are concept charts for income insurance. This is actually an outline of the main concepts in order to understand "income insurance" which means the more recent type of benefit that attempts to fit the payments to the actual loss.

The early definition is in box one. This involves a "status definition" of loss. Something John Miller would have called a medical definition. In effect, it says if you achieve this status, you are awarded benefits, you are defined as disabled. The presumptive definition (seventh box) carries on this concept by saying, you are entitled to benefits if a certain loss occurs. Some of the resulting definitions have been very liberal, loss of use of a function, for instance, voice is one of them that is the most liberal.

Inability to perform all the duties of your own occupation is mentioned in the next box down, which would be number 13. Modifying these is a phrase which is added to the provision that says you cannot perform all the tasks of your own occupation and you are not working at another occupation. That takes away some of the liberality of the original version.

Moving over to the second column we get an interest in the residual need. Residual definitions provide for what is left after a certain period of total disability. Often, insurers were paying a benefit after one year of total or two years of total for whatever was the residual income loss. The residual concept involves a definition, see the lower portion of box 8, (QP stands for qualification period). The elimination period was not enough to define this benefit. You had to have a period of total loss prior to being qualified to receive residual loss benefits.

Box 14 brings out that the main feature of the residuals is that they paid a percentage of the full monthly benefits depending on what the income loss was. Some early policies did not do this, and one of them (which is one of the most notable) finally changed over to proportionate loss from the dollar-for-a-dollar income replacement type of approach. The problem here is that with the proportionate loss you may have inequities and you may be unable to take account of the individual's other coverages. I believe there is one policy out now under which it is detrimental to the policyholder to have any other coverage because all of their items are offset against main benefits.

The chief criticism of the residual was risk of any early retirement, box 20. As many have noted in the past, the risk occurs even without residual definitions of loss.

The final stage, before the "backsliding" is the pure income loss in column three. This means that there is no definition of disability. There is a requirement that the loss be caused by sickness or accident that occurs while the policy is in force. Some of the other features that go with pure income loss are arrayed in different boxes around the page. What happens with pure income loss is it requires a lot of record keeping and it is not a convenient policy to administer. I have questions like in box 22, what is income? Are we talking about a cash basis or incurred basis? Box 28 asks what proofs of loss are required? How much bookkeeping work do you have your accountants do just to file a claim? Note, this actually deters some claimants because of all the accounting requirements.

Another external influence on the development of these current provisions is economic. In box 4, the key point is inflation. The boxes around and beneath box 4 take-up the responses, guaranteed issue options, basis for index benefits - all these are in response to the problem with inflation.

In the fifth column where we get to the social insurance substitute or supplement rider. Here we are now trying to improve the scope of benefits. Some benefits from Social Security for instance, may never be paid. The SIS concept we have attempts to cope with that. Eventually we get down to a full offset of benefits as in box 17. If all of these things can be offset then you have the perfect fit, presumably: Social Security disability income, workers comp., state cash sickness, automobile no-fault insurance, civic service benefits and in fact, all of the array of benefits that are listed in the HIAA study as sources of compensation when disabled. Box 35 warns you to have the provision in the policy to be able to cope with changes in administration of the social insurance program. Many policies contain this right. They will have a maximum that the premium can be increased to, usually the premium for the totally nonintegrated benefit. You cannot charge more than you would for the nonintegrated.

The items in the sixth column all relate to financial underwriting considerations. Who pays the premiums? (Is it the employer or the individual himself?) How do you treat unearned income? How do you set the replacement ratio for your underwriting limits? What are the tax impacts? All of these questions are needed in order to decide upon a reasonable replacement ratio.

Two income families are becoming more a factor. And the treatment of other coverage is certainly a sensitive issue. I'd say that the current trend in the plan design is aimed to fit - fitting the benefits to the changing needs of the insured and to the presence or absence of other coverage.

If you wish to pursue this, I have listed a couple of other sources. I would suggest that you read the last few issues of John Miller's Disability Newsletter where he gives a very detailed history of how we got to where we are. The Record of the Society of Actuaries will include discussions on the same topic. In the beginning of the Time Saver, which is a National Underwriter publication, shows all the definitions, for instance, of presumptive loss, all the requirements in a disability policy. It is a good checklist to see what other people are doing. A number of marketing publications also could be consulted and I have looked at these and mentioned them in other situations like Life Association News, almost every other issue will have something on the marketing problems of selling disability insurance. The CLU Journal has an article once in awhile. Health Insurance Underwriter takes up these same topics. Best's Review is a good one. I have been looking at the accounts in Business Insurance because they have followed pretty much what is happening in the workers' compensation area.

Please look at Box 31 on your chart. The Florida wage loss is in reference to the fact that the permanent partial benefits in Florida are now being restricted to actual wage loss rather than being awarded based on status, like how many fingers you lost in the punchpress. The spread of this wage loss approach to six other states that are now using this kind of approach and the cost of workers' compensation has been reduced by this change.

In conclusion, I would say that if your company is looking for a simple disability income product today, you might as well forget it. It is only going to be found at the sacrifice of basic underwriting principles and I have the feeling, but I cannot prove it, that it is not going to be profitable. And, that is the last word I would be concerned with -- profit.

MR. GERALD PARKER:

1. Pricing

Slide 1

Price may not be a contract provision, but price wars are not unknown in our business. So it pays to take a quick look. Here is a coverage that is no longer on the market, but it is not very different from what we are seeing today. It is noncan only to 60, but it provided lifetime benefits all the way, plus 50% for up to six months for partial disability.

Slide 2

Now for the rates. Compare them with the modern rates on the right. Everyone likes to think he is No. 1, but this one is a leader, and no low-ball leader, either.

Are they different enough? Given the coverages differences and environmental differences, they had better be. Because that old policy and the rates on the left led to the mystery company's insolvency in the great depression. It was the old Pacific Mutual Life Insurance Company of California, from whose ashes arose the present day Pacific Mutual Life.

SLIDE 1

THE MYSTERY COMPANY

-

LIFETIME A&S

PARTIAL DISABILITY FOLLOWING TOTAL

50% - SIX MONTHS

PRESUMPTIVE - BLINDNESS - ANY TWO LIMBS

LOSS OF ONE EYE - 10% FOR LIFE
ONE LIMB - 25% FOR LIFE

NONCAN TO AGE 60

SLIDE 2

PREMIUM COMPARISON
MEN - BEST CLASS
30 DAY A&S ELIMINATION

Age	Mystery Company Noncan to 60 With P.D.	Co. No. 1* (Lifetime if TD From Sickness Before 50 Noncan to 65 Without RD	With RD
35	$ 62.50	$ 48.42	$ 55.00
40	70.00	$ 58.58	$ 67.46
45	79.50	$ 70.26	$ 81.16
50	90.50	$ 85.56**	$97.97**
55	102.50	$105.02**	$117.73**

* $1.00 added for policy fee

** No lifetime sickness

2. Definitions of total disability

No contract provisions are more controversial. None have evolved more rapidly or radically. How risky are all the changes and innovations?

Whence came we? All is not new. Lifetime occupational definitions existed in the 1920's. They disappeared in the 30's. The replacements gave one year of an occupational definition; then they required complete inability to engage in any occupation or employment for wage, compensation, or profit! Try that one on your doctor prospects!

The courts, as might have been expected, refused to interpret that literally, and in the 1950's, carriers started writing the policies the way the courts were interpreting them. Words like "any substantially gainful occupation for which the insured is qualified by education, training or experience" began to appear. The one-year occupational definition was extended to two, then five, then ten years, and finally to "forever".

Where are we now? A reasonable starting point is the NAIC minimum standards definition. It is a good definition. It requires that the insured be "totally disabled from engaging in any employment for which he is or becomes qualified by reason of education, training, or experience and not in fact engaged in any employment or occupation for wage or profit". Some states require a year of occupational coverage. Most companies offer two or five year, or indefinite occupational coverage, depending on occupation. Total disability can be defined as "inability to perform all the substantial and material duties".

So what is being done? Here's a selection in rough order of imprecision:

° ..unable to perform the material and substantial duties of your occupation...

° ..unable to perform the duties of your occupation...

° ..unable to perform the important duties of your occupation and not actually engage in any other occupation...

° ..you cannot do the main duties of your occupation...(reduced benefits if "you" can do some, but not all...main duties...or work no more than three-fourths...hours)

° ..unable to perform the principal duties of his occupation...

What is the importance of these variations? How will court interpretations of "important" and "principal" and "main" duties compare with interpretations of "all the substantial and material", or just "the duties"? It will be years before we are sure. But ask your claim adjusters how they would feel about each of these definitions when they are dealing with a claimant they think could work if he wanted to.

Loose language has a price. What it will be for untested changes is anyone's guess. It is high in hard times. Who will pay it? The non-disabled will - in higher premiums. The truly disabled will - by subsidizing malingerers. And if worse comes to worst, your shareholders or other mutual policyholders will.

Tremendous competitive pressures have arisen from the indefinite occupational definition. It has come to set the standard of quality in the doctor market. Perhaps unfortunately, agents and brokers have been sold on the notion that nothing else is right for any of their business and professional clients, whether those with generalized office and management duties, or the specialized as in surgeons, or super-specialized like the surgeons who operate only on the cornea of the left eye.

Does it make sense? Sure it does - for the specialist who earns a very high income by the use of <u>physical</u> skills. And he is willing to pay the price.

Now, suppose you add a residual disability provision that pays a reduced benefit if the insured returns to his former specialty at reduced earnings, but pays full <u>total</u> disability benefits if he changes to another specialty, no matter <u>how</u> much he earns in the new work. Is this rational? Do irrational coverages tend to be successful? Can this one be priced? Suppose you increase your morbidity assumptions for attained ages over 50 and assume a claim termination rate after 50 that equals standard mortality? Would that do it? Could be. But will it do for the 32-year old pediatrician who cannot take the strain of night calls and switches to child psychology? At only $8,000 a month, you will pay him $3,168,000 by the time he is 65. Discounted at 7%, the present value is nearly $1,300,000. Perhaps you can buy a long term bond at 10% with call protection? Any way you look at it, you are talking a million dollars or more. Can you or should you price for that?

3. <u>Residual disability and pure loss of earnings</u>

This concept was invented in Edinburgh, Scotland. It developed out of exgratia settlements. Insured claimants suggested to the company (Friends Provident Group) that they could work at some new job or enterprise, though for lower earnings, but would forfeit their total disability benefits under their contracts if they did so. Would the company make a deal? It would and did. It worked, so they put it in their policies. They pay a reduced benefit, a fraction of the total disability benefit proportional to the percentage loss of earnings if the claimant engages in a <u>different</u> occupation.

When we imported this concept, we made an important change. We broadened it to cover partial loss of earnings from return to work in <u>any</u> occupation - including the original one. In my case at least, I did it, because I needed something to compete with the indefinite occupational definition. I thought then that is was risky, but less risky than the occupational definition. I still do not know for sure if I was right. No one does.

The big risk was early partial retirement. To minimize that, we required a qualification period of total disability, and compensable total disability at that, before the insured could qualify for residual disability benefits. Residual disability was what the name implied. A rehabilitation motivator for partial disability following lengthy total disability. And the more the claimant actually earned, the more he had in his pocket. There was always an incentive to full recovery, because the benefits reduced less than the earnings increased.

About the same time as residual disability benefits were appearing, the pure loss of income concept made its appearance. Disability was not even defined, much less required. Any loss of earnings exceeding 20% that resulted from injury or sickness was compensable. Originated by American United Life, this concept has been imitated or modified by several other insurers. There are ordinarily no qualification requirements in these policies.

It did not take long for the qualification period concept to be eroded in the more conventional residual disability policies. First the compensability requirement went, then the period of total disability required dropped. And before long, we had what is now called "zero day qualification period". To all intents and purposes, pure loss of income and zero day qualification periods amount to the same thing. And most of the major competitors offer the zero day QP, at least to their top occupation classes, and at least for disabilities beginning before about age 55.

Just how big is this risk of early partial retirement? I happen to think it is enormous. Having successfully attained an age that exceeds 50, and having many friends and associates who have done likewise, I have had lots of opportunities to hear people's views of their life works. I find, to my surprise, that many of them eagerly anticipate retirement as soon as they can afford it. I hear comments like "As soon as I get the kids through college, I am going to get off this rat race. I am going to retire and open a photo shop (tackle store) (book shop) (country inn)". You name it. And some have done it.

Now how many of you enjoy the services of claim approvers and attorneys who are prepared to allege and prove that such a person is <u>not</u> partially disabled by inability to take the emotional strain of the "rat race" any more? And how many of those people are going to be happy partially retired with reduced expenses on half their former earnings, a partial pension, half your policy's benefit, and lower taxes? It will be a good many years yet before anyone knows.

But one of the first things I was taught in my old casualty insurance days was that you cannot give your insured the ability to control both the occurrence and the severity of the loss insured. If you do, you insure disaster - for yourself. But is not that what a liberal, long term, partial disability benefit without a requirement of a preceding honest total disability does for a person who is old enough to be thinking of early partial retirement as desirable?

4. <u>Social insurance offsets</u>

These are about the only developments of recent years that have <u>reduced</u> risk (if they are properly priced) at the same time they make higher practical limits available to insureds. For years, everyone assumed you could not do this in individual policies because of the <u>Insurance With Other Insurers</u> provision of the Uniform Law. But it did not turn out to be so. The so-called "all or nothing" social insurance substitute approach that I developed at Guardian and that one or two others worked out at about the same time has been approved in all states, and the full direct offset approach that Jack Caton developed at AUL has been approved in all but three or four.

This development presents us with one problem and one major risk. The problem arises from inflation. If you put a direct offset provision in a fixed indemnity policy of $1,000 a month on the assumption that the social insurance benefit will be about $500, but inflation indexing increases the social insurance benefit to $1,000 or more by the time a claim is incurred, the policy will pay no benefits, and the insured is likely to be very disturbed indeed. And how do you price that? It seems to me that such a policy must provide for indexing of the initial benefit on some basis if it is to be equitable.

In the case of the all-or-nothing approach, failure to increase the SIS benefit as potential social insurance benefits increase will decrease the replacement ratio, and hence the insurer's risk, but may also call for some future increase privilege to satisfy the buyer.

The risk is in pricing. Once again, no one is sure what the value of the offset is. Some have suggested that, since Social Security Administration (SSA) has been cutting off claimants and denying claims at a higher rate, almost no one can qualify, and hence the benefit has become underpriced. Some companies are assuming that receipt of Social Security is so unlikely that they are ignoring the possibility. If they are wrong, and I suspect they are, they may be somewhat upset by the claim experience that can arise from replacement ratios that can easily exceed 100% of pre-disability <u>gross</u> earnings.

Most Social Security disability claimants are unskilled workers over 50. But so are most long term disabled <u>people</u>. For years, SSA did almost no follow-up on its claimants. Benefits were low, and a fair number of those beneficiaries found they could work some. I suspect that group accounts for a large fraction of those SSA is now cutting off. And I doubt that the new criteria will have nearly as much effect on business and professional claimants. They have always had to be severely disabled to get on claim.

Do not forget that, if a person has a condition that appears in the "medical listing", he is presumed disabled for Social Security purposes unless he is <u>actually</u> engaged in "substantial gainful activity". A large majority of <u>all</u> Social Security disability awards are based on medical factors <u>alone</u>. Over 60% of the ALJ (Administrative Law Judge) reversals of DDS denials are based on medical factors.

On the other hand, the pricing risk is very real. Most of the pricing has been extrapolated from Social Security, worker's compensation, and other social insurance experience with guesswork adjustments for occupation class variations. It will be a long time before we know how close we have come.

5. <u>Future increase and COLA (Cost of Living Adjustments) options</u>

These have sprouted and grown like dandelions in the Spring. I have heard it reported that some carrier or carriers are offering future benefit increases without financial underwriting. If true, our business has invented yet another unmeasurable risk. Otherwise, the main difficulty would seem to be pricing the antiselection, or possibly reducing it through benefit design.

As to COLA's, we have them with simple and compound indexing, we have them with and without maximum caps, and I have seen at least one that does not even require any inflation. It just increases the monthly indemnity annually, come what may. Now that would worry me! Just when we seem to think we can predict the course of the economy, it has the disturbing habit of confounding the experts. I would hate to bet on permanent inflation. And if the worldwide collapse of financial credit that is being talked about comes to pass, the certain result would be severe deflation. I need not dwell on what that would do to us!

But here, too, the main problem seems to be how to price it.

6. Renewal provisions - noncan or guaranteed renewable?

During the panic of the mid-seventies, the convention halls and trade press were filled with the rhetoric of terrified CEO's (Chief Executive Officers) warning that the premium rate guarantee would destroy the industry. Thus far, both the guarantee and the industry have survived. What are the pros and cons?

The notion of being able to raise premiums if things get out of hand is certainly appealing, especially when we are busily adopting so many of the new and risky unknowns we have just been talking about. But it is not in the policies with all those unknowns that I see the right to raise premiums being reserved. It is in the mostly conservative policies being sold to blue collar risks.

Just how useful is the right to raise premiums in these classes? Even absent the inherent antiselection, I suggest that it may be counter-productive. Several states now require loss ratios on GR (guaranteed renewable) policies five points higher than on noncan. And five points on the gross means nearer ten on the net. The per policy expenses are no lower. Are the commissions lower? Certainly, the lapse rates are worse than on the better classes. It seems to me that you must give up substantial margins for the right to raise premiums, and I wonder if this is the class of business you want to give them up on. Personally, I would rather have an adequate rate with a higher margin to start with, especially in view of the high lapse rate.

7. Limits and replacement ratios

Slide 3

Where are we and where are we going? Average earnings have about quintupled in the past 30 years, but look what has happened to limits! I did not even put 1983 on the chart, because there are no more set limits for some companies. It is true that few can qualify for the $10,000 to $15,000 a month we hear about from time to time. But the surgeon who claims a half million dollar net after business expenses is no longer a fiction.

Slide 9

I suppose everyone here has seen some data that demonstrates how claim costs tend to rise with the benefit level. Duane Kidwell of Paul Revere has provided me with these bar graphs that show their experience along these lines. This slide shows you top class actual to expected claim costs for various size groups. The 1978 claim costs varied from about 75% of expected on policies of $500 a month or less to over 120% on policies that paid more than $2,000 a month. Other Paul Revere data demonstrates that the phenomenon runs in the same direction as to both frequency and severity and through all occupation classes.

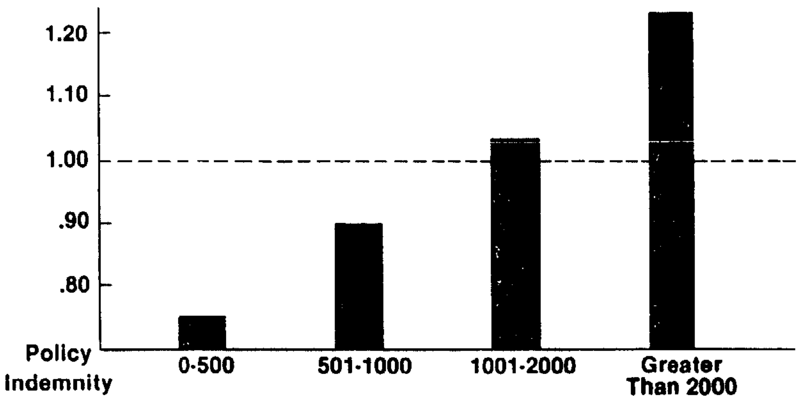
SLIDE 3

TYPICAL LONG TERM LIMITS

YEAR	LIMIT	LIMIT INDEX	AVERAGE WAGE INDEX
1952	$ 400	100	100
1961	$ 550	137	137
1967	$ 800	200	175
1970	$1,650	413	208
1973	$2,200	550	255
1977	$3,500	875	329
1979	$4,500	1,125	386
1980	$5,000	1,250	422
1981	$6,000	1,500	464 (Est.)
1982	$7,000+	1,750	508 (Est.)
	SIS	2,000	

SLIDE 9

Claim Cost A/E Ratios
Standard — Male — By Amount
Class 4A — 1978 Claims



SLIDE 10

Standard Males — Claim Payments (000) omitted

	Actual	Expected	Ratio
1977 Claims, All Classes, Second Claim Year	$2,407	$2,478	.971
1975, 1976 Claims, Class 4A Third Claim Year	$ 743	$ 752	.988

An important question is, does this experience tell us anything about how results on policies of $10,000 or $15,000 a month will behave? Will their claim costs relate linearly to those on policies of $2,000 a month and less? Will they relate in some other way? Indeed, will they relate at all? Are these super-earners so highly motivated that their experience will actually turn out to be better than expected? No one knows, and no one will know for a good many years. Meanwhile, limits available continue to soar.

8. Experience lag

I may be berating the obvious, but I have repeatedly suggested that we will not know much about the effect of innovations for years. I would like to show you a few simple slides to demonstrate that.

Slide 4

The first is just a couple of rough curves. They are not precise, but the message is that you sell most of your policies to people in their early thirties to mid-forties, but you pay most of your claim dollars to people over 50.

Slide 5

The next just demonstrates how fast your new business grows if your sales increase at 10% or 15% a year for 15 years.

Slide 6

Now we see how many of each year's sales dollars are still around after 15 years.

Slide 7

This sort of ties it together. If your sales increase at 10% a year, and your lapses are 150% of Linton A, only about 17% of your in force will have been seasoned for ten or more years after fifteen years.

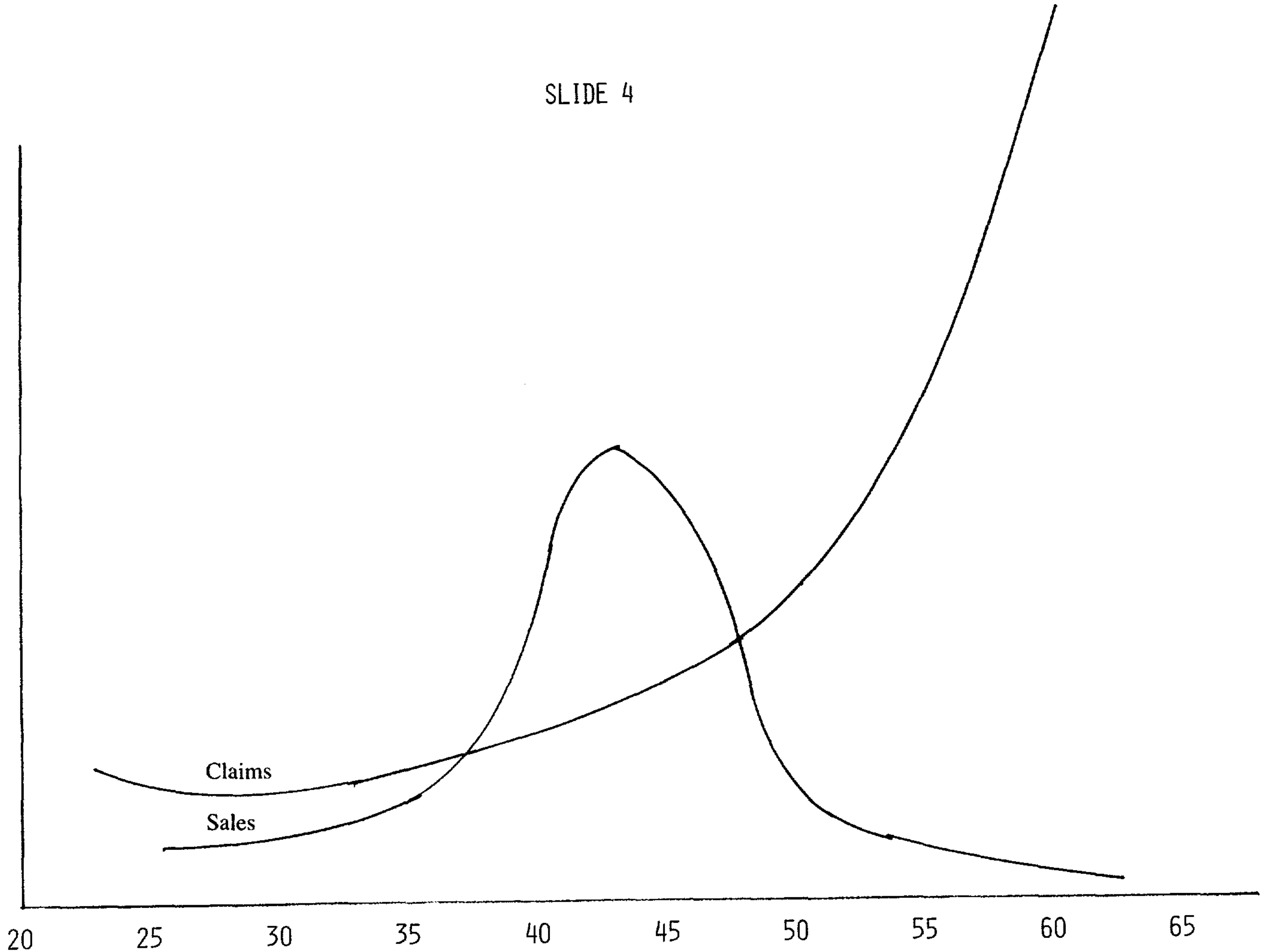
Slide 8

And if your rate of sales increase is 15%, only 12% will have been around for ten or more years at the end of 15.

Why this statement of the obvious? Because some of these liberalizations and innovations are going to be unsuccessful. Some are going to be disasters. No one knows for sure which, and no one will for some time to come.

I realize that I must have sounded like a Cassandra. My assignment has been to identify and discuss provisions and underwriting that may lead to future losses. I have tried to do so. That does not mean I think they all will. What it does mean is that we should be aware of these risks as we innovate and liberalize in quest of all the fish in the pond. Some degree of prudence would seem appropriate. It is no good catching all the fish if they turn out to be poisonous. And no one wants another 1933, or even a 1975 if we can avoid it.

SLIDE 4



SLIDE 5

YEAR	RATE OF SALES INCREASE 10%	15%
1	$1,000,000	$1,000,000
2	1,100,000	1,150,000
3	1,210,000	1,323,000
4	1,331,000	1,521,000
5	1,464,000	1,749,000
6	1,611,000	2,011,000
7	1,772,000	2,313,000
8	1,949,000	2,660,000
9	2,144,000	3,059,000
10	2,358,000	3,518,000
11	2,594,000	4,046,000
12	2,853,000	4,652,000
13	3,138,000	5,350,000
14	3,452,000	6,153,000
15	3,797,000	7,076,000

SLIDE 6

150% OF LINTON A
LAPSES
$1,000,000 SALES

Year End	In Force
1	$846,000
2	766,000
3	704,000
4	653,000
5	609,000
6	571,000
7	539,000
8	511,000
9	485,000
10	461,000
11	439,000
12	418,000
13	399,000
14	380,000
15	363,000

SLIDE 7

$1,000,000 SALES

SALES INCREASE RATE 10%

LAPSE RATE 150% LINTON A

In Force - End 10 Years	$10,311,000
In Force 10 Years +	4.47%
In Force - End 15 Years	$19,069,000
In Force 10 Years +	17%

SLIDE 8

$1,000,000 SALES

SALES INCREASE RATE 15%

LAPSE RATE - 150% LINTON A

IN FORCE - END 10 YEARS	$13,438,000
IN FORCE 10 YEARS	3.43%
IN FORCE END 15 YEARS	$29,761,000
IN FORCE 10 YEARS +	12.0%

MR. DAVID SCARLETT: I will state my conclusions right up front. I do not see that the marketers of individual disability insurance have a very good record of innovation over the past 15 years. The industry has been preoccupied with a very small segment of the market (professionals and other high income earners) resulting in many changes, a great deal of competition, but little substantive change to benefit the consumer. If we do not break out of this mold I see little real change over the next 10 years aside from that forced on us by legislation and regulation.

After briefly reviewing the recent past, I will look at possible changes to current product provisions and underwriting rules. I will then discuss the fundamental analyses I believe we all should be doing to better serve the public. I will conclude with some possible major external influences and some product ideas that we all should seriously consider.

The last 15 years have seemed hectic and full of change, but what new really happened? There was some innovation and experimentation in the higher income markets with long residual benefits, income replacement policies and periodically financially reunderwritten policies. There were external factors:

1. Unemployment and inflation led to poor experience in the mid-70's, a trend away from lower class markets, and Cost of Living riders.

2. Legislation and regulation (including expansion of government programs) led to more attention to actuarial adequacy and minimum loss ratios, social insurance offset benefits, and simplified policy language.

3. Changing levels of income and changes in the work ethic led to much more emphasis on financial underwriting to guard against overinsurance.

But most of what has been called "change" has come from intense competition in the areas of higher issue limits, longer "regular occupation" definitions of disability and shorter residual disability qualification periods. Terminology such as "dual definition" and "triple indexing" has emerged. I do not consider these changes substantive. Competition has, in many cases, moved to the foolish level, which in the long run will benefit no one. This can be clearly seen, for example, in the wording of definitions of disability. The cost of insurance for honest people has been increased because we have liberalized our contract provisions and underwriting so that dishonest people can and are taking advantage of us.

Now let us look at some specific policy provisions and benefits and I will make a few comments on each. In general I do not expect substantive changes in the future. Please note that my discussion will center on noncancellable disability products, especially those sold to better occupational classes.

1. Renewability -- There will be a trend toward allowing policies to be renewed as long as the insured is working full-time. But this will not have any real effect since almost everyone will still retire prior to age 70.

2. Definitions of disability -- The industry has gone about as far as it can go. We have made very fine, probably unenforceable distinctions.

3. Waiver of premium -- Many companies now waive during both total and residual disability. There will be no major change here.

4. Exclusions -- More and more companies will take out the exclusion for normal pregnancy. However most companies remove this provision extracontractually in many situations now.

5. I really see no changes worth mentioning in recurrent disability provisions, definitions relating to earnings, and incontestable provisions.

6. Policy parameters -- There will undoubtedly be minor changes in elimination periods, qualification periods, and benefit periods. But I would like to specifically mention three trends in this area. First, some companies are allowing people to become disabled as late as age 60 and still get lifetime benefits. It is my feeling that these benefits are very costly, and there is really no economic need for them. Second, there is a trend in qualification periods to not requiring any period of total disability prior to getting residual benefits, even at the higher ages. This will merely allow those who want to retire early to take advantage of us. Third, I hope the companies will continue the trend toward coterminous accident and sickness benefits and away from accident extensions.

7. Premium factors -- Aside from unisex, which I will discuss later, I believe there will be two major changes. First more and more companies will examine their modal factors and conclude that the semiannual and quarterly factors need changing. Second, most companies will adopt nonsmoker discounts.

8. Sizzles -- Every company has provisions in its policies that provide no significant benefit but are there to make policy comparisons more difficult. Many companies will adopt one or more provisions such as presumptive disability, transplant donor, rehabilitation, death benefits, and minimum residual benefits during the early months of disability.

9. Social insurance substitute riders -- With the expansion of social insurances, companies will tend to expand the use of these riders and benefits they offset.

10. Cost of Living riders -- I am afraid that the disturbing trend toward having no cap on increases will continue.

11. Guarantee of Insurability riders -- There will be a trend toward issuing higher amounts with the idea that most of the insured's future needs can be taken care of in the one policy.

12. Business insurances -- We should not forget to examine possible changes in overhead expense insurance, disability buy-sell insurance, and key-man insurance. It is hard to talk of changes for buy-sell or key-man because there is no well-defined product. For overhead expense I see a trend toward coordination of benefits so that the insured is not reimbursed more than his loss.

Now let us take a look at underwriting rules. Again, I am primarily discussing rules for the better classes.

1. Application forms -- There will clearly be modifications to these forms to reflect the reduction in information needed for simplified underwriting and higher nonmedical limits. The formats may also change to accommodate the increased use of computers in underwriting.

2. Physical underwriting -- Nonmedical limits will continue to increase. Better studies of substandard issues will be available to guide the underwriter.

3. Financial and other factors -- Higher incomes and the complexity of our tax laws will mean even greater attention must be paid to financial underwriting. Factors such as unearned income, net worth, and tax shelters must be carefully evaluated. There will be increasing use of financial questionnaires. There will also be a need to carefully monitor the value of social insurances and government employee benefits.

4. Occupational classes -- Companies will continue to be under tremendous pressure to upgrade their occupational classifications. Because of competitive pressure, many occupations that do not deserve to be in the best class will be put there anyway.

5. Multiple sales -- There will be continued expansion in competition with respect to employer-employee groups and associations. Discount programs will be expanded and there will be continued liberalization of physical and financial underwriting concessions.

As you can see, I do not feel that anything extraordinary is going to happen regarding our current products and rules. I strongly feel that we all must go back to fundamentals and examine our potential markets. In particular we should examine:

1. What products are needed to service that market on a competitive and profitable basis?

2. What is the best marketing approach to penetrate each market? We must look at career agents (sophisticated and/or unsophisticated), brokers, direct mail, client companies, national accounts, and reinsurance.

3. What sort of underwriting is needed to best service the market? This includes both physical and financial underwriting.

4. Careful consideration must be given to coordinating products with other areas of your companies (e.g., group health insurance).

With these factors in mind let's take a look at some possible markets. With respect to personal disability income insurance there are the following markets:

1. Professionals -- This area has been getting all of the attention and I see little new being introduced.

2. High income nonprofessionals -- We must come to grips with what limits and products we will make available to people who are making a lot of money but who do not have the stability of a profession.

3. White collar clerical -- Most companies adequately provide for this market.

4. Retail merchants -- I believe that adequate coverage is available. There will, of course, continue to be problems as to how to classify the owners of these businesses. There is a great opportunity here for expansion of business insurances.

5. Blue collar -- It is probably not reasonable to sell noncancellable coverage in this market. Clearly there is room for innovation.

6. Low income -- For many companies minimum issue limits are now over $20,000 a year. I do not believe that the product has yet been designed to properly service this market.

7. Senior ages -- I strongly feel that there is little legitimate need for new disability insurance after age 60. Any product development in this area will probably center on providing coverage to help comply with age discrimination laws.

8. Targeted risks -- There will be opportunities to make money with a properly designed product in occupations such as pilots, truck drivers and government employees.

9. Specialty products -- Companies will always be faced with the need to design simplified products for the untrained agent. Some possibilities that suggest themselves are disability products for homemakers and to provide mortgage protection.

The business market provides great opportunity for innovation. This is a largely untapped market and existing products are not well-defined. What I'm talking about is: overhead expense for business owners, disability buy-sell, key-man disability insurance and sick pay plans.

Now I would like to speculate on possible external influences that will have a major impact. The greatest influences will come in the area of legislation and regulation.

1. Risk classification -- If we cannot use our current risk classifications, obviously there will be major rating problems and major market dislocations. I will discuss the sex discrimination problem separately in a moment.

2. Taxability of disability benefits -- It is hard to believe that a juicy source of revenue like taxing disability benefits will escape for long. This would mean that we would have to rethink all of our financial underwriting rules. Certainly higher issue limits would result.

3. Coordination of benefits -- If legislation allows complete dollar-for-dollar coordination among individual policies and government programs, then I believe there would be a major swing toward fully integrated policies. There would also be the attendant claim administration problems.

4. Government workers -- It is clear that more companies would enter the government employee market if universal and uniform benefits were enacted.

5. Nonforfeiture values -- Some companies already have return of premium benefits, but mandated nonforfeiture values would require higher premiums. Also health actuaries would have to start worrying about traditional life insurance problems like the investment element in their calculations to a much greater extent.

6. Expansion of social insurances -- This will lead to higher minimum incomes required to buy our products. Perhaps different offset products will be needed.

7. Actuarial monitoring -- Monitoring and loss ratio requirements will require major changes in actuarial procedures.

8. Senior citizens -- We may be required to sell coverage, regardless of age, to people who are still working.

9. Preexisting conditions -- There is a trend toward limiting the time period and the definition for preexisting conditions. We should be careful not to overlook the effect this might have.

There are a number of administrative factors that will affect our products.

1. Computer produced policies -- This will lead to greater accuracy, easier state approvals, easier implementation, less costly printing and storage, and a better appearing policy.

2. Computerized systems -- Currently advances in computerized proposal systems, application systems and issue systems will allow for faster issue and more complex products.

3. Service -- The better we can handle changes in an insured's policy, the better we can serve that insured by making sure that coverage can change as needs change.

There will be a number of changes due to actuarial influences.

1. Monitoring and loss ratios -- There will undoubtedly be much more attention paid in these areas. This will cause changes in rate filing and reserving procedures. Companies will have a better handle on new business, ad agencies, geographical problems, occupations and substandard experience.

2. Risk classification -- Even without legislation there will be changes. For example, lower rates for nonsmokers.

3. Changes in benefits -- In order to service the client, companies will have to come up with simple and equitable ways of changing benefits in existing policies.

One last thought on external influences. The products that we can sell are dependent on the nature of our marketing organizations. We may develop the best product in the world but if we cannot train the field to sell it, or if

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 field does not have access to the intended market, then the product will be a failure.

Is there a chance of some really revolutionary things happening? The answer is yes, I think so. In the area of legislation there is a high probability of some form of unisex rating being mandated. There will be many different approaches to handling this problem, but I suspect that most companies will end up segmenting the marketplace. Since the professional market is almost all male, companies may make their present products available with the male rate. Male rates may be used with the present products for people with high incomes such as over $40,000 a year. The rest of the market will be divided among as many different policies as necessary so that the percentages of females and their effect can be reasonably estimated.

Two other possible products are a joint disability policy and some sort of universal health product. The joint disability policy would be issued where both spouses are working and it would pay a lower benefit if only one person is disabled and higher benefit if both are disabled. The universal product (analogous to Universal life) might consist of a pool of accumulated premiums from which morbidity charges (and perhaps even mortality charges!) would be deducted for all coverages on insureds and dependents.

To summarize, I am in favor of change and I am very much in favor of competition, but I would hope that competition could turn in a more productive direction. We must continually examine our products and carefully balance the differing needs of the company, the field, the regulator, and the consumer. Whatever changes we make in the next ten years will not show up as claims for a number of years so we must give each change our best thinking.

MR. BRUCE OLSON: I would be interested in the smoker and nonsmoker discount. What is the level of the discount? Are companies using their own experience or are they just guessing? I am looking for some idea of the relative adjustment in premiums compared to those which have been sold in the past.

MR. SCARLETT: My company does have nonsmoker discounts and I think we have been pretty conservative in the amount of the discount. It varies between 5% and 7%. It is a higher percentage for the longer elimination or the longer benefit periods. No, we are not relying on our own experience. We are guessing by and large. As a matter of fact our guess is that the effect of smoking or nonsmoking on morbidity is really much more substantial than the discounts that we are offering in our premiums. We have been in touch with State Mutual who has also been offering nonsmoker discounts. They really did not provide us with very much direct information but they indicated that their percentage discounts, which I guess are roughly in the 5% to 10% area, were being pretty well substantiated by experience. We also took a look at the surgeon general's report on smoking which deals a little bit with the effect of smoking on morbidity. If you take a look at that you conclude that there is a significant effect of smoking on morbidity. So, to summarize, by having a nonsmoker discount we are accumulating experience that we will be able to analyze in the future. It is our feeling that when we analyze that experience, we are going to find that we really could have given a much larger discount than we are.

MR. HABECK: There has been some work on the relative effect of age. I seem to remember that some of State Mutual's experience indicated early on that the difference between smoker and nonsmoker experience was greater at the younger ages than at the older ages. I found this to be rather interesting since all that I have ever read or heard about the effects of smoking is it starts to hit people over 40. And most of the degenerative heart problems, respiratory problems, and cancer problems affect the older people. So, it would seem to me that if you combine the fact that the lapse rates on people that buy disability insurance in their 20's and early 30's are generally quite a bit higher than buying at the higher ages, I would think they have a much greater effect from a pricing standpoint on the people that buy at the higher ages.

MR. BRADLEY LEONARD: I am intrigued with the idea of the universal life type of approach to disability income. I have had the experience of developing and filing a rider to a life contract on a true disability basis where the rider actually floats through the disability income line of business. Such a concept flew in a large number of states although there are certain states that would not even deal with the concept because of regulations. For those that do, I presume that this could be done by using riders also. I am just wondering what other kinds of additional ramifications there would be.

MR. SCARLETT: My impression is that perhaps you have gone further than anyone else. This was just a "blue sky" type idea that I thought of in trying to put together this presentation and I am very interested to hear that you have already broken some ground in that area. I think that is great. Did you say that the rider provided disability income benefits?

MR. LEONARD: We were trying to encourage package product with our company. We issue to age 60 and use only three elimination periods to keep it simple. We anticipated lower lapse rates because of the tie in with ordinary commission rates which were high front end but really a lower present value because of lower renewals. It started to go over pretty big, although we did not have a lot of experience with it when I left.

MR. SCARLETT: How long have you had that?

MR. LEONARD: I think I did that back in maybe 1979 or 1980. I developed it at Wisconsin Life. It was just beginning to get off the ground. You almost had to deal personally with each agency. When we put together a combination of rate sheets for each agency they would take off on it. It started off pretty big in the farm market for example, but we only went down to our third occupational class. We did not go all the way down to blue collar. So there is the chance to upgrade that market as well. There were not too many out there, so it was a chance to do something different. I think there could be a lot more potential but there are a lot of administrative complications with it.

MR. MICHAEL KELLEN: I would like to add a little something to that. One of my associates at Mutual of Omaha, Mr. Bob Shapland, came up with an idea similar with this about 10 to 12 years ago. Although we have not done anything with it at this point, we have not given up on the concept. His idea was more of the universal insurance policy -- all lines. It is a workable situation at least from the logistics standpoint. From the practical standpoint and a legal standpoint, I do not know where the problems would lie. At least it appears you can carry this concept all the way.

MR. PARKER: The idea of putting this kind of thing on a universal type of policy is of course new and exciting, but the concept of combining life and disability insurance goes back to the early 20's at least and maybe longer. It died in life insurance because disability insurance got to be so much more attractive and so much more flexible. With the old-fashioned life policy you would get $10 a month or $5 a month per thousand. Other reasons for the death of this concept were serious underpricing during the depression and some of the loose underwriting that was done, like doubling the benefit after 15 months and having a 90-day retroactive elimination period. It cost hundreds of millions of dollars for the life companies in the 30's. Back in the early 50's Occidental Life had something they called a policy with a heart. It was nothing but a straight disability policy that you could only buy if you purchased a life insurance policy from them at the same time. We imitated that at Guardian in 1952 and came out with a product, where the price was discounted and the commission was discounted. It sold pretty well for awhile, but I think the main problem was that it required special training. It was the old keep it simple concept. A lot of agents, especially the beginning type agent and the ones who are not too heavily trained have a very difficult time coping with two concepts at one time. They are much more comfortable with going out and selling one and then coming back when they deliver the policy to sell the other one. There is the phenomenon that seems to be out there in the field which works somewhat this way, that the agent works like the devil and as soon as he sees the guy get his signature on an application for something the one thing he wants to do is get out of there before the prospect changes his mind. He doesn't want to bring anything else up when actually he is probably in the best possible position to bring something else up. The few that do it are often very successful but it is hard to change habits.