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BUSINESS USES OF INDIVIDUAL DISABILITY INCOME PRODUCTS

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MR. RICHARD B. MARX: I am Dick Marx, an Assistant Vice President and Actuary at MONY, the Mutual Life Insurance Company of New York, and I will be your moderator. We will concentrate on four products: products to cover disability buy-outs, overhead expenses, keymen and keywomen, and salary continuation. We intend to discuss markets, product design, pricing, tax angles, reinsurance, underwriting, claims, and the Norris decision.

Let's now hear from Gerry Parker, as he covers marketing, tax angles, reinsurance and the Norris decision.

MR. GERALD S. PARKER: My job is to deal with four aspects of the subject.

Marketing

The first is marketing, and it's by far the most important aspect of the subject. Because without good marketing, you get no business. And this is a tempting market. It has needs, and it has money. The big problem is access. Without access, the best product in the world won't sell.

Overhead Expense

Let's start with overhead expense. Here there are really two sub-markets. The first and most profitable - if you have the access - is the self-employed professional. This group seems to account for something like 65% of the sales and maybe 75% of the premiums. The second is the small business owner. In both groups, you may be dealing with sole proprietors, partners, or close corporations. And rarely is there a good sale when there are more than five or six principals.

Some companies class the near-professionals -- people whose special skills aren't readily provided by their employees -- as professionals for underwriting. Usually, they have to be licensed to operate. Examples would be property-casualty agents, independent life brokers, and financial consultants. Wholesalers, retailers, manufacturers, tradesmen, and others of similar ilk are definitely a different market. They're usually offered policies that exclude employee salaries from the definition of business expenses.

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Salary Continuation

The salary continuation plan market is potentially by far the largest and most interesting one. Essentially, it is all the small, close corporations making lots of money. It includes professional corporations, but they are a smaller factor. And most of these prospects have the need and the money. The technical requirements are not complicated. You need a good non-cancellable product, a quantity discount, a first class presentation, and an agent with a good knowledge of the applicable tax results - which are not at all complicated. And access. Always access.

How do you reach these prospects? It depends on access. It's the key to success in all the business markets. You have to work in terms of what kind of a company you are, who your agents are, how much they earn, who they sell other products to. If most of your agents are earning $20,000 or $30,000 a year, they are not going to sell insurance to people earning six figure incomes. There's no way in the world that those agents are ever going to get face to face with those prospects. The agents who can sell these plans are the estate planners, the CLUs, the ChFCs, the pension specialists. Because these are the ones with access.

Disability Buyout

When it comes to the disability buyout, the market is the same as the market for the life buyout. The two really ought to be a single sale - except where your agent finds a funded life buyout in force, but disability ignored. That's the best prospect of all. He's already been sold on the problem. But he only has half the solution.

How big is the buyout market? This is a question I hear very often. Reinsurers tell me nobody is doing anything. However, this market, too, is enormous. But it's also a very difficult one. It's the same people that you sell salary continuation plans to. Here the agent has an even tougher access problem. He has to be much more knowledgable. All the technical problems are more complex. Just having a good product and a qualified producer won't do the job. Yes, the agent must have access. Yes, the product must be good, and there are only a very few really good ones on the market today.

But much more important, you must back it up with the sales presentation material and the sales training to put it over. And that has to be backed up by home office people who know the marketing problems, are first rate disability underwriters, and who are also skilled financial underwriters who understand financial analysis, balance sheets and income statements, business valuation, and personal negotiation. The major players in the game have lawyers and accountants available as consultants to their underwriters.

How big is the buyout market? Really, in terms of what a successful company can actually write? I believe not more than a tiny handfull of companies have actually written enough of this business to justify the investment necessary to be in the market. But many more could do it - with the right marketing, products, underwriting, and reinsurance. I know most about The Guardian Life, because I was there. The Guardian was the first

to come up with underwriting principles that made it practical, and I got it started in 1968. I forget how much business we actually did in the first year, but I'd guess no more than about 20 cases, perhaps 60 or 70 lives.

In 1982, The Guardian wrote about 1600 new buyout policies with about $700,000 in annualized premiums. That was about 15% of the total number of policies they paid for and about 12% of the premiums. It's probably a somewhat smaller share today, because their regular disability product has been updated, but the buyout product hasn't.

Key Employee

This market is mostly theory. In no way can it justify a special product. Yet it *requires* a *conditionally renewable policy*, not a *non-cancellable* one, because it can disappear so fast. But it's a great agent conversation piece. *Agents love to be able to discuss it with clients, but it rarely* gets sold. Why, I don't really know, because I've always been told that a fair amount of key person life insurance is sold to employers. Or is that just talk too?

I think there's one sub-market where a ton of it could be sold, and very profitably too, given the right product and marketing. That's the insuring of large, guaranteed salary contracts over their terms. And it's practical to do it. Consider a single premium, non-renewable policy. It can be done, because I got one approved once. And very large amounts of reinsurance can be arranged. I know that, too. Do you think the letter houses could run with such a contract? How do you like insuring the Chairman of the Board of a major big board corporation for $250,000 a year (half his salary), until the end of his 5-year contract? But nobody has done it yet.

Taxation

Taxation plays a big part in the business disability sale. Without some tax leverage, that sale won't be made. And it's there in all of them.

Business Overhead

In overhead expense insurance, you have a very simple rule. If the contract is one of indemnification for actual loss, the premiums are deductible as ordinary business expenses. The benefits are taxable income, but they are offset against expenses, so it's a wash.

This raises a question in my mind. Of late, the salestypes have been hanging a lot of Christmas tree ornaments on the once simple overhead expense policies. . . . things like "presumptive disability" definitions that pay business expenses, even if the insured is not really disabled and thus suffers no loss, and others that will pay 100% of expenses if the insured is 80% or more disabled; things of that nature. Are these still contracts of indemnification? And will the IRS challenge the tax deductibility of the premiums when it catches on? I hope the marketers that are developing these things talk to their lawyers now and then!

Salary Continuation

If a corporation buys disability insurance under a "plan for employees", several very desirable tax results occur. But first, the plan must meet the statutory and regulatory definition of a "plan". It had better be in writing. It must have been communicated to the employees. However, as long as it is an insured plan, it can discriminate in favor of highly compensated employees.

If the plan qualifies:

1. The premiums paid by the employer are deductible as ordinary business expenses.

2. The premiums are not taxable as income to the employees.

3. If the benefits are made payable to the employer, which then acts as a conduit and pays them to the employees, the premiums are not deductible, but the employer receives the benefits tax free.

There are also some very good reasons for not doing this on an informal, ad hoc basis. Without a "plan", salary continued to a disabled shareholder-employee will probably be classed by the IRS as constructive dividends, and thus subjected to a double tax whammy - first to the corporation as profits instead of deductions, and then to the disabled owner as dividend income.

There's a dodge to watch out for. Sometimes an employer gets smart - too smart. He reduces the employee's salary by the amount of the premium. Then, if there's a claim, he'll reverse it for the last year. If the IRS catches him on this, they'll disallow the premium deduction. And the employee just might squeal, because if he does, he's going to get the benefits tax free. And at that point, the insurance company will probably find he's over-insured, because it has probably issued higher limits on the assumption that the benefits would be taxable.

Buyout

The premiums are not deductible as business expenses, and the benefits go to the owner (or his trustee) tax free. When the buyout is accomplished, the gain or loss to the disabled owner is treated as a capital transaction. By using an installment buyout, this gain can be spread out over several tax years.

Key Employee

The owner cannot deduct the premiums, but he receives the benefits tax free.

Tax Law Citations; Regulations and Revenue Rulings
IRC 104 (a)(3), 105(d), 106, 265(1)
Regs. 1.105-5(a), 1.162.10
Rev. Rulings: 55-264, 1955-1 CB11
66-262, 1966-2 CB105

Reinsurance

Since the good prospects for business insurance are making lots of money, policies tend to be large, and so do premiums. So reinsurance becomes important.

Overhead Expense and Salary Continuation

Here, there's no problem. At least one reinsurer has pretty much open limits. For salary continuation, they are usually higher for non-contributory cases. Others have nominal limits around $10,000 per month, which they will bend mightily for the right cases - sometimes to double the published values.

Buyout

For buyouts, the situation is not as good. One major reinsurer will work with $360,000 on an installment buyout with two-year elimination period, $500,000 with three-year wait. On lump sum deals, it demands a three-year wait for $500,000. One reinsurer sets installment buyout limits at $150,000 with one-year wait, $250,000 with two, and $500,000 with three. These limits have not been significantly increased for at least five years. Underwriting is case by case, and there's a tendency to want at least a 50% retention by the direct writer.

It's time for a change. Business net worths and profit potentials are increasing. Close corporation business valuations well over $1,000,000 per shareholder are no longer rare. And overly long elimination periods or lengthy installment payout requirements make no sense to the buyers. Elimination periods up to two years can be sold. But the working partners want the sick one out of there long before three years. One year wait is often wanted. Installment buyouts should be options, not requirements.

Somehow or somewhere, we have to dig up more reinsurance sources or more imagination on the part of the players. I believe in the buyout. We made it practical at The Guardian in 1968 with a $36,000 limit! We got it up to $360,000 maybe seven or eight years ago. There it has pretty much stuck for lack of reinsurance, because three to five year installment options simply are not salable. Values have doubled since then, but reinsurance limits haven't moved. Yet, to my mind, the risks in the buyout are far less per life and far less potentially overall than the risks the reinsurers are eagerly grabbing every day in some of the crazy things that are being done in long term disability.

Norris Decision and Unisex Rates

Do we have to go "unisex" on all these business coverages? Some say "yes", and some say "no".

The "yes" people feel that "Norris" is the tip of the iceberg. They say there's language in the decision that could lead courts in future cases to use it as a precedent to apply unisex rate requirements to all employee insurance. They fear continued use of sex distinct rates in business situations could result in retroactive adjustment requirements flowing from

such decisions. As I understand it, the rationale is basically the tendency of courts in recent years to write liberal social legislation in the form of court decisions.

The "no" people feel that's extremely unlikely. They say that "Norris", like "Manhart", has extremely narrow applicability. It applies only to contributory qualified pension plans. Just as "Manhart" dealt only with sex distinct benefits arising from equal contributions, "Norris" deals only with sex-distinct contributions leading to equal benefits. In this view, you might lose some insurance cases where employee contributions are sex distinct, but there is virtually no risk if benefits are equal by sex and the plans are non-contributory. Neither "Norris" nor "Manhart" deals with employer contributions in any way.

The "yes" contenders respond that, even if "Norris doesn't apply to employer-paid coverage, any conversion or continuation right could bring the whole plan under "Norris". The "no's" answer, "No way. If the employer owns the policies (which he should in any case), he is under no obligation to transfer ownership to terminating employees. If he does transfer a policy, there is no consideration. He does it voluntarily. And the employee takes it over simply because it's a better deal than buying a new one would be. But it's in just the same category as it would be if he had bought it new from the insurer after the termination."

And that about wraps up an introduction to my four topics. There's lots more we could cover, but I hope what I have covered will generate some discussion.

MR. MARX: Thank you, Gerry. Dave Baxter will now discuss product design and underwriting.

MR. DAVID L. BAXTER: As a means of briefly introducing my topic of product design and underwriting, I'd like to first drop back to some very basic actuarial principles of effective product design and underwriting. These are, that proper product design and underwriting in combination are necessary to assure, first, insurable interest, and secondly, to assure a minimal incidence of unintended use or misuse of benefit provisions. That is, those claim situations where benefits are found to be payable in what would generally be felt to be very inappropriate circumstances.

In other words, these two very important functions of product development and underwriting should assure that a given product, in a given market, is priceable -- that average expected costs can indeed be calculated or estimated over the long run -- to make this entire process more of a science and less of the occasional "crapshoot" that sometimes arises in the design and marketing of these products.

Now, leaving the purely actuarial perspective, and looking at these two functions from a broader marketing or business perspective, we see the function of underwriting to be, in fact, the identification and selection of specific market segments. These segments are traditionally defined relative to health characteristics, occupation, income, or even work ethic attributes. Product design, then, is the process of effectively meeting the true disability needs of these market segments. There is a strong belief that the above principles of insurable interest and minimal product

abuse are best assured by effectively identifying clients with true disability needs and designing products which most effectively meet these true specific needs. Thus, marketing, underwriting and product design must work in concert to assure long-term success and profitability in a given market or product category.

So, a lot of what Gerry had said relative to marketing is also highly relevant to effective underwriting and product design, and I'll be referring back quite frequently to identifying client needs and designing products to effectively meet these needs.

Referring back to Gerry's talk also gives me a convenient way of structuring my own remarks, so, as Gerry did, I'll begin with the Overhead Expense Product.

The basic client need for this product is, very simply, the need to avoid having to close a business down completely during a period of disability.

Who is it that has this particular need? We found that clients who have an appropriate need for this product share two basic characteristics: first, the income of the business must be related to personal services. And secondly, a significant loss must be suffered by the business in the event of disability of this person. These general rules of thumb greatly simplify the decision of who should be insured for this coverage, but admittedly leave many of the traditional underwriting problems surrounding this product "unsolved". And, as Gerry mentioned, we still end up with a product that appears primarily to be most appropriate for professionals. Many salesmen continue to have the problem that they are generally replaceable by other salesmen, that a significant loss does not occur since clientele are not as directly connected to a specific personality as they would be to, say, a doctor. Store owners continue to have a problem in that the business generally does not suffer a significant loss in the event of their disability, that generally in these cases the business does continue to run. Also, there are many instances where a much more appropriate coverage is Keyman Coverage. I'll be discussing this later. Finally, although there is no hard and fast rule, it is obvious that as the size of business or partnership increases, the underlying significance to the business of the loss of any one person diminishes. Thus, even in underwriting professionals, the appropriateness of this benefit decreases as the size of a firm increases.

Relative to the design of this product, the actual types of expenses covered seem to be one of the most burning issues these days. We found that it helps to have one general rule relative to covered expenses, that is, is it necessary to keep the business open and running? This rule of thumb recently lead us to revise our contract to cover mortgage principal in addition to interest, since in the normal course of doing business a mortgagee would be expected to continue to pay principal to the mortgagor. Also, there are many large annual expenses which are most appropriately expensed on a pro rata basis, such as malpractice insurance. However, with many of these new capital draw type concepts, care must be taken to avoid having these "accounts" taken down over a very short period of time, thus effectively reducing the contract to a very short term contract, when the original need might more appropriately have been for a somewhat longer period of time. Not only does this create a potential pricing problem, it

may encourage purchase of benefits which are in actuality smaller or shorter in duration than the client actually needs.

Finally, there are the actual practical aspects of underwriting this coverage. I think it's appropriate here to note that one major difference of many of these business related products is that the aspects of financial underwriting become much more significant. This goes way beyond the traditional approach of underwriting the health risk, and many companies are finding that their underwriters must be expert in understanding and underwriting the financial aspects of a business, not just individuals. In fact, the complexity of the issues of determining true income amounts, obtaining accurate, reliable information, and assessing the viability of a business have led many companies to actually put CPAs on their staffs.

The next area is Salary Continuation Programs. Gerry has already talked about the client for whom this product is most appropriate. Although the needs of this market are very similar to individually sold products, it's important to note that there are some significant differences, primarily additional needs due to corporate involvement. Generally, when there is employer involvement, there are significant needs for ease in administration and billing, ease of issue and underwriting, often a need to cover substandard or uninsurable employees, or a need to cover low paid employees, and sometimes a need for higher amounts for certain key employees.

There are certainly some significant underwriting issues surrounding this product. First, of course, is the question: Is an individual product really appropriate for a particular case? I've seen many instances where sales personnel or the underwriting department forgot to ask this simple question and ended up with a real boondoggle where individual products were simply too complex and too complicated to administer to meet very basic corporate employer needs. Although I don't personally have any hard and fast rules, it appears that the larger a case becomes, and the more it is looking for ease of administration, low cost, and universal coverage, the more appropriate a group vehicle becomes and individual products are simply not appropriate in these cases. Certainly, there are many valid exceptions to this rule, particularly as individual employee's (or member's) needs or desires for specific individual policy features increase, or as the need for traditional tailoring and flexibility increases.

Assuming, then, that individual products are appropriate, one of the major issues is that of the guarantee issue of individual policies. There appears to be quite a bit of this occurring these days, and I've certainly seen a lot of guarantee issue cases that have really surprised me relative to how liberal they are. Many of these offers have gone way beyond what has traditionally been available in the underwriting of group products, not to mention the more liberal and risky nature of the individual product to begin with. Certainly, sound group underwriting principles, at a minimum, should be operating here. Minimum participation should be required. I've seem some looseknit associations that have received offers almost designed to encourage anti-selection against the company.

Often, the apparent need for guarantee issue underwriting is actually driven by a need on the part of the employer for a simplified process of issuing policies. This need can often be met by using simplified

underwriting requirements, such as a short form application, without having to give away the whole store! Some companies are even merely utilizing a statement or census from the employer. One major risk here, though, is that, unlike group insurance, individual contracts are actually an agreement with each individual employee. Thus, misrepresentations on the part of the employer cannot be remedied by any action relative to a policy held by an employee. This a major disadvantage of the individual policy mode of meeting this need.

The need for covering lower paid employees should be treated very similarly to the need for coverage for impaired or uninsurable risks, i.e., sound group underwriting principles should prevail.

Finally, it's important that the amount issued to each employee be appropriate. Most companies now offer higher amounts when the case is corporate paid, and this certainly appears appropriate, given the expected tax treatment to the employee. However, it should be noted that it is possible for an employer to pay the premiums, but actually own the policy. This disallows the employer from receiving a tax deduction, but at claim time a very interesting thing happens. The insurance proceeds are received tax free by the employer, and the employer receives a tax deduction for any amounts paid to the employee under a salary continuation plan. Assuming a 50% tax rate for illustrative purposes, if the employer receives a $1,000 monthly benefit, he would be able to pay out $2,000 a month, and essentially break even after taxes. Thus, it is possible for an employer who is willing to forego a current tax deduction of premium to actually indemnify an employee for twice the amount of insurance the company actually thinks it is issuing.

Next is the area of the Disability Buyout Policy. The need here is one of providing funds for the purchase of a business in the event of sustained disability of one of the partners. This is a very real need, and indeed the market must be very large, especially when you consider all of the life insurance buy-sell agreements that are in force today. However, somehow the insurance industry has really not done much of a job penetrating this market. Certainly one of the major reasons for this must be the complexity and aggravation of trying to underwrite this product. Although complaints from the field force are many, relative to the underwriting of this product, I doubt they are as frequent as complaints about the underwriting from the underwriters themselves.

First, there is the issue of the actual valuation of the business. Although the actual process of valuing a business is similar to that for life insurance, we have certainly traditionally felt a greater need for more preciseness in the disability underwriting. This generates a lot of argument relative to whether we should use market value, book value, or some other measure for the valuation of a business. This valuation gets even more complex for closely held corporations and partnerships, which appear to be the primary markets for this product.

Next is the area of impaired risks. This can be a difficult issue for a life insurance agreement. It is even more difficult in a disability situation since insurers are not routinely used to using five (5) and ten (10) times ratings. And, of course, in these sales situations, a waiver

for, say, a back problem of one partner is generally very unfavorably received by another partner.

Finally, the last burning underwriting issue appears to be the one of should underwriting require to see the actual buyout agreement prior to issuance of the policy? Many companies in the last few years have waived this requirement, and have designed their product to key off of the actual existence of a buyout agreement. Thus, from a theoretical perspective, it might actually be possible for no benefit to be payable at all if no buy-sell agreement was ever entered into. In addition, some companies actually fine tune the valuation of the business at claim time, by requiring the scheduled amount to bear some reasonable relationship to the value of the business at that time. I have often wondered exactly what the legal risks are inherent in this approach. However, it certainly has simplified the underwriting and issue process. My greatest concern here actually lies with my own skepticism relative to the difficulty of obtaining the buy-sell agreement. What is actually happening out there? Are agents attempting to sell these policies without actually going through the more sophisticated process of having a buy-sell agreement completed for the partners? Are the clients not involving their attorneys or accountants? If so, is this really long term in the best interest of the client? I think we insurance companies have a long way to go before we really understand exactly the process that is generating this business.

There are a couple of product development issues which emerge with this product. First, should the benefit be an installment benefit or a lump sum payment? My own feeling is that the lump sum is most appropriate since the decision to transfer ownership generally occurs all at once and not piece meal. In fact, partial transfers of ownership can create significant problems for both partners. Installment buyouts often are appropriate, particularly for tax reasons. However, there is no need in these agreements to maintain the disability contingency of the installment payout. Thus, an installment certain, triggered at some point during the disability, is probably most appropriate.

Certainly, there will be instances where the lump sum is not as appropriate as some other arrangement, but for the most part, I feel the lump sum comes closer to meeting the needs of the business.

What definition of disability should be used? The question should be, at what point does it become appropriate to transfer the business? At what point does a particular partner cease to be an effective business partner? Ideally, the definition should relate specifically to the business being insured and to the specific duties required to be an integral part of that business. And, most definitions currently being offered do come very close to meeting this ideal.

In the area of Key Person Insurance, I tend to agree with Gerry that there may be a very limited market, primarily in the area of large employment contracts, often with salary guarantees.

If this is so, this certainly creates a need for a very different product than is currently being marketed. The terms of these employment contracts are generally fairly short, 2-5 years, so a level premium product to age 65 is very inappropriate. The definition of disability should certainly

relate to the terms of the contract. Thus, it may actually be necessary to tailor-make each definition of disability, either placing it on the schedule page, or attaching a copy of the employment contract as part of the insurance contract.

How much should the payout be, and how long should it be paid for? To answer this we really must relate back to why this product was sold, which is basically as casualty coverage to a company which may have a strong vested interest in the performance of a contract. What is the actual loss to the corporation? This may be significantly different from the actual salary paid and will certainly cause a commotion in the underwriting department.

Other underwriting issues which need to be addressed are health problems on the part of key employees, and I think most importantly the actual underwriting of the business itself. Is this a viable business, and is it doing business sensibly to be placing so much of its hopes on the performance of one or a few key employees? Often, the stakes are so high in these situations that it places them outside of the realm of the way we traditionally view the insuring concept.

To sum everything up, I would say that the product design and underwriting of business products is very complex, including all complexities of traditional individual products, and additionally many issues relating to unique needs and underwriting problems. I would also echo Gerry's words that this is a major marketing opportunity and probably well worth the extra effort required to really understand these business needs and the specific underwriting problems associated with them.

MR. MARX: Thank you, Dave. Our final presentation will now come from John Lenser, primarily on the subject of pricing.

MR. JOHN LENSER: My assignment, on this panel, is to bring to it the perspective of a pricing actuary -- at least with regard to the several Business Related Disability Income (BRDI) products on which I've worked. Gerry and Dave have talked about marketing, policy design and underwriting. I expect my remarks to overlap theirs somewhat because the functions of the pricing actuary, policy designer, marketer, underwriter, etc. are unusually tightly intertwined on BRDI coverages.

I. Introduction

The process that the actuary must apply in the pricing of BRDI coverages is essentially the same as that for other disability coverages. There are various characteristics of the market for business-related disability insurance, however, that require that the pricing actuary focus his attention in different areas than if he were pricing other DI products. In order to establish suitable actuarial assumptions, the actuary must familiarize himself with -- and perhaps define and limit -- such things as the business arrangement with respect to which insurance is being provided, the definition and underwriting related thereto, the product flexibility or variety that different business situations may require, and other such elements that will affect actuarial assumptions. In selecting actuarial assumptions for use in BRDI pricing, the actuary is also likely to have to

interpolate/extrapolate from existing experience or synthesize using data from several sources not directly related to the product that is being priced, since BRDI often consists of new and/or changing coverages. These aspects of the pricing of BRDI make the task somewhat more difficult, complicated and uncertain than the pricing of traditional DI products. It's very much like the pricing of what we would call experimental coverages.

In the remainder of this presentation, I will describe certain of those characteristics of the market for BRDI products that make their pricing different. I will include a few examples of aspects of product design and underwriting that affect actuarial assumptions and will also describe ways in which we see their impact on actuarial assumptions.

II. Market Characteristics

Let's talk about market characteristics. In the area of market characteristics, there are four broad aspects of the market that significantly influence product design, underwriting and claims, and which, consequently, are important in establishing actuarial assumptions.

If we were to briefly label those aspects, we might use the following descriptions:

1. The sophistication of the consumer.

2. The position of the insured within a business structure.

3. The product linkage into operations of a business.

4. The implications of strongly needs-oriented products.

Let me talk first about what I mean by "sophistication of the consumer".

The market is sophisticated. By that I mean that it is comprised of purchasers of the coverage, and users of the benefit, who are sophisticated both as purchasers and users. And they may become "abusers" rather than just "users" of BRDI products if such products are not well designed. The sophistication of this market is one of the factors in making it highly competitive, and a consequence of such a highly competitive, sophisticated market is that BRDI coverages will almost certainly have to be "leading edge" coverages.

"Leading Edge" characteristics will be necessary not only in regard to the fundamental design of the product (which I'll mention later) but also with regard to complexity of the pricing structure. This can require many kinds of premium structure distinctions including, for example:

-- the use of non-smoker class and perhaps preferred risk class premiums

-- the provision of discounts for genuine "volume savings" which are realized by the insurance company when several, or more, individual policies can be billed to one business on a single billing

-- the use of a superclass; if an insurer does not already have a "superclass" (accountants, physicians, actuaries, etc.), it will have to introduce such a class in order to market BRDI coverages successfully

-- special premium scales, on other than a strict issue age basis, may be desirable to handle some coverages with unusual renewability expectations.

There are other similar distinctions that may be appropriate in certain circumstances. Much time may be consumed -- perhaps wasted -- in trying to decide which such distinctions are worthwhile, and which are not.

Second, some BRDI coverages -- in fact -- most -- are in some way related to the position of an individual insured as defined within some business structure. The individual's position, his function, within that business structure may be as

-- a sole owner
-- a partner, among many partners
-- a partner, among only two or three partners
-- a key-person
-- other.

These functions, or these positions, within a business structure introduce risk factors that are different from, and in addition to, the usual occupational considerations, and therefore additional complications are added to the pricing actuary's problems of defining, classifying and measuring risks related to BRDI.

Other underwriting and policy design questions, including complications that may arise with regard to defining who is a keyperson, what truly comprises a 4A type of business executive versus a 3A, or what is a covered business expense, may well affect the pricing actuary's assumptions as to morbidity levels, issue expenses, underwriting expenses and expenses of claims administration.

Third, the market for many BRDI coverages is linked to the operational structure of particular kinds of businesses. These are generally small businesses owned and run by sole proprietors or by a few partners. Consequently, we have to deal with such things as the definition of business expenses, the contribution of different partners to the income of the business, and the proper split of expenses of operation among the partners of a business. Certain actuarial assumptions, especially lapse rates and most types of expenses -- underwriting, policy issue, premium collection, policy maintenance and claims administration -- will be affected by these and other factors related to the operation and structure of the insured's business. Persistency, for example, will be influenced not only by the characteristics of the individual, as it is with non-business DI coverage, but also by characteristics of the business in which the individual is involved.

Fourth, the market for BRDI coverages demands semi-customized, strongly needs-oriented products, and the needs may change frequently. As a consequence, experience data that arise directly from products of the type

that are to be priced may never be available or may be available only in trivial quantities and may have a low degree of reliability. In a sense, then, we may find that our task in pricing BRDI coverages is the task of repeatedly pricing "experimental" coverages, even when -- nominally -- the coverages have been around for many years. It's one thing to price "experimental" coverages when they are cancellable or guaranteed renewable, but quite another when they are non-cancellable.

Small companies may find BRDI coverages especially difficult. The volumes of business generated by these products may be small, and the large amounts at risk -- especially on Business Buy-Out coverages -- may result in very large fluctuations in experience. The need for reinsurance is apparent, and the availability and cost of such reinsurance are therefore important to the pricing actuary.

For an insurance company that already has some BRDI coverages in force, the problems of determining appropriate actuarial assumptions for an additional new kind of BRDI coverage are lessened. All companies must expect to have such problems, however. The largest DI writers with much general DI experience and a full line of BRDI products may be able to set actuarial assumptions for new or modified BRDI coverages by basing the assumptions largely on their own experience and relying only to a small degree on actuarial judgment. That's one end of the spectrum. At the other end of the spectrum, there are small companies with no existing BRDI coverages, no 4A pricing class and no general DI experience in any reliable volume. My own experience as a pricing actuary in a consulting role has largely been with companies whose BRDI experience is rather limited. A fundamental question that arises here, then, is whether smaller insurance companies, which may only do small volumes of business on Business Buy-Out, Keyperson or even Business Overhead Expense coverages, can afford to bring such products to the market, if frequent re-design and repricing are necessary?

Given a fairly expensive product design process, complicated and expensive pricing, and elaborate underwriting and claims administration procedures, it may well be that smaller companies will choose not to develop such products, but will prefer to provide products for their agents by looking to other large DI writers as a source of BRDI coverages.

Let me conclude with one example that illustrates a little bit the kind of pricing problems that we have confronted on these products even when we had a company with a relatively large amount of disability income experience going back many years on a variety of products and with the experience available to us in great detail. Their experience was not on business related products; they had none whatsoever, and they had no superclass and no experience in the 4A class. We went back and looked at their experience in order to price a Disability Buy-Out plan. We were looking at plans with lump sum benefits payable at several points in time, one year, two years, or three years, and we had their experience on traditional Disability Income products, as I say in great detail. For various elimination periods, we knew the frequency of disability at durations one, two and three years. We are then faced with the problem of determining such things as, if you know from your traditional coverage how many people are going to be disabled for a year on a monthly pay-out benefit, how much do you have

to adjust that experience to allow for anti-selection at the time of lump sum payment. Clearly, you are not going to expect to see the same kind of continuance rate. If you have X% of your disabled lives remaining disabled for a year on a monthly payment policy, you are going to expect something maybe closer to the number who are disabled for ten months to be disabled on this coverage. Similarly, for the lump sum payments at 24 months and 36 months. We have used actuarial judgment in dealing with that aspect of it.

Second, as your basis for determining continuation of disability, you use experience arising from plans with a 30-day elimination period or 90 or 1-year or some other period. How much do those factors, those adjustments to your continuation rate, vary by age? There is some feeling that as you get to older individuals who are closer to retirement they are more likely to use this coverage as a retirement coverage. And, therefore, you have to load up more perhaps at higher ages. When you have made adjustments of that sort, and come up with some answers, and you want to do the kind of reasonableness testing that you might normally do, or competitive comparisons, you run into problems again. This is especially true on a coverage like Disability Buy-Out where the structure of the benefit is so different from one company to another. It makes it very difficult to compare premiums with other companies to see whether you are competitive or not, and for those of you who like to use competitive premiums as a slight indication of reasonableness in premiums, you have a great deal of difficulty doing that also. That's an example of the type of difficulty you run into in pricing these products.

In summary, you can say that generally because of limited availability of data on these products, and their many different policy designs, they tend to be very complicated products to price and generally involve a great deal of actuarial judgment.

MR. MARX: Thank you, John. We will open this session to questions and comments from the audience or from panelists.

MR. CARL L. LOEFFEL: It seems to me that for several of these coverages, we are talking about insuring a job rather than an occupation. I would like to have comments from both Gerry and probably Dave as to the structure of these benefits. Are we actually insuring, for instance, in the Keyman and Buy-Out contracts, a job, rather than an occupation?

MR. PARKER: Most of the early contracts used conventional definitions of disability. One of the selling points was that customers could use the policy definition for their own purposes as to when their partner was or was not disabled. I think most of the definitions of disability that I have seen in more recent policies define disability as inability to engage in the regular occupation or any other occupation within the company. I think this makes a lot of sense.

MR. BAXTER: I tend to see a lot of these coverages (certainly Keyman) as truly insuring the job. Especially if we consider the markets that both Gerry and I were talking about, which are very select short-term contracts, essentially 2-5 year salary contracts, that is, a job and may have nothing to do with the long term occupation of any sort. To the extent possible, existing products and contracts offered today should be tailored to that specific insuring situation, which in most cases is a job.

MR. PARKER: That is definitely true in Keyman. A little illustration. The first Keyman case that I can remember involved a telephone call from an agent who said he had a client from a bank in Amsterdam, New York, which was in a pretty depressed area. This was a long time ago. The banker said he had a chief loan officer and he was paying him $9,000 per year and if this individual got disabled he would have to hire someone from one of the big banks and pay $25,000 to get the job done and could he insure this loan officer for $25,000 for disability? It was an interesting proposition. We didn't take $25,000, but this is how we got started in the Keyman business.

MR. DAVID S. BEER: Has anyone done anything about what is essentially the problem that disability Buy-Out is not individual insurance, but has merely been forced into the individual contract form? Namely, you are really insuring the business, and the existence of a Buy-Out being triggered has effects on other partners. What renewal provisions and/or other things can protect you against that?

MR. BAXTER: I think that is an easy question because I am not aware of anyone who has, and I am not aware of anyone who has even done that in life insurance. It is an interesting concept, and you're certainly right that the insuring situation is essentially a special sort of group coverage. I am not aware of anyone who is covered in any other way. Maybe Gerry has seen something.

MR. PARKER: I cannot add much to that. It is an interesting idea. The sales pitch has always been in terms of the same pitch that has been made for life insurance Buy-Outs, that the disabled partner is going to be a burden on his family, and that the family is going to be a burden on the company. If the company doesn't have the funds to purchase the disabled partner's business interest, the firm is in trouble and the disabled partner and his family are in trouble.

MR. LENSER: I have one comment that is maybe not directly responsive to it, David. It's an interesting situation in that on coverages like that, you may well be willing to guarantee a premium rate. You are willing to have a pricing structure where you guarantee a premium, but you don't want to be stuck with a non-cancellable guaranteed renewable type coverage because renewability provisions don't make sense. You want to be able to terminate it at some point. It is even more of the case on keyperson, where you end up with a hybrid kind of relationship between the renewability provisions and your willingness to guarantee a premium rate.

MR. PARKER: What we did at Guardian when we started writing the Keyman, and I guess they still do, is make the employer sign an agreement that he would never transfer either the benefits or the ownership of the policy to the employee. And we could write this Keyman on top of the personal coverage. Of course, we knew that the paper he signed probably wasn't worth much in court.

MR. GERALD A. FRYER: In terms of the pricing of office Overhead Expense coverages, I have observed that benefit period for benefit period, these seem to be lower cost than regular income replacement coverages. One of the reasons for this is that people generally take into account the fact that the total benefit may not be paid if all of the expenses aren't lost.

MR. LENSER: The policy designs on these business related coverages vary a good deal from one contract to another. But, I think on those that I have typically seen, I would expect in pricing a one-year benefit that it wouldn't be too drastically different from a one-year traditional disability income benefit, and that you might expect to pay the full monthly amount month by month. In the case of a two-year benefit though, I can understand that you would see quite a difference between the premium rates on a traditional two-year disability income policy and a business overhead expense coverage, because you expect in many cases to have some salvage. The business won't last two years, and you won't have a full two-year payout of benefits as you would on a traditional disability income policy.

MR. BAXTER: Our own experience has been that we have seen very few businesses where the disabled person did not remove himself from the business within about a 6-month period, either by shutting down the business, selling it, or turning it over to partners. So, what we found is that our policy is a vouchered policy, that is, we will not pay unless there are actual expenses. Between three and nine months, those expenses declined very rapidly, and in most cases were non-existent by the end of six months. So, we see very significant differences in the pricing aspects of the overhead expense versus an indemnity income replacement contract, although the differences for longer durations, to go from say one year to two years, is not really significant because most businesses are shut down by then.

MR. MARX: How about the one-person buyout situation? Can you write coverage on a sound basis on a one-person buyout, and, if so, what should you be looking for?

MR. PARKER: Very dangerous. A one-person buyout situation really amounts to a corporation owner, like me, with a one-man corporation who figures that if he gets disabled, he want his family to get the value of the business out. It is just too dangerous I think to fool with. It is an interesting side-light here in what you do with a corporation owned by two people and one of them becomes a disabled. Then you've got a one-owner situation left.

MR. MARX: Do any panelists have any questions they would like to ask?

MR. PARKER: I would like to comment a little on the business of seeing the contract versus trying to handle it in other ways. When we started doing this at Guardian, we insisted on seeing every contract and making sure that it met the requirements for a decent agreement. After we had seen the first few of those, we were pretty sure we were right, because the attorneys that attempted to draft them did such a mess of it that we usually had to have it rewritten four or five times. This created a certain amount of difficulty in the underwriting process and it still does. We also felt that we knew that many life buyouts were never written. The policies were sold but the agent never followed up and the lawyers never even followed up. On the life buyout, the insured wasn't going to die for years, and most people figured it would be forgotten before it happened. With the disability buyout, we weren't so sure about that, and besides that, the insured would still be alive, so they would be

more likely to complain if it didn't work. So, we felt that we had some obligation to see that there was a document that would work. As the thing grew, this just became impossible to administer and we gradually liberalized. First we developed systems where we took assignments for small cases, and that's gone up to much larger cases now. But what we really did was write an assignment to a trustee, and, with the benefits assigned to a trustee, and the trustee only entitled to pay out the benefits under the terms written in the assignment, this amounted to the essentials of a buyout agreement. Then, some other people began to write policies and handle this on an indemnification basis. They put the requirements of this kind in the policy, and that seems to be the way to go. I think I'd still like to see a contract if I were underwriting it when you are talking much over half a million dollars. But, for most of the cases, I think you ought to be able to handle it in the contract.

MR. BAXTER: I would echo your concerns that a lot of those actual agreements are just not being written. I do question whether the client is being fairly treated in this situation. He's got a contract, he's paying a premium, but maybe he doesn't even have a valid buyout agreement in effect. Maybe a benefit will be paid, but who knows whether there really is an agreement for ownership to actually transfer.

One of the most interesting things that happened to me about my second week in my new sales position was that I went out on a presentation, and this was for a group of eight CPAs, and my presentation was basically to teach them the tax treatment of wage continuation plans. I was just flabbergasted that I would be telling them this. I thought they should be telling me this. So I know that in these business markets, the intermediaries tend to be accountants and lawyers quite a bit, and I think they are very lacking in some areas of expertise about these products. So, maybe the first area we need to concentrate in is more general education and the importance of these coverages.

MR. PARKER: In fact, some of the most successful agents in these markets are being successful by running seminars directed to accountants and lawyers. They get them into a meeting room and give them the picture on this, or on pensions, or what have you, and then go back and seek to use them as entrees to possible sales.

MR. LOEFFEL: Dave, you mentioned that overhead expense is dying off at say around 6 months. How about when you get into these group practices where you have three or four doctors, and where they all assume say 25% of the expenses of the corporation? In that type of situation, should there be different underwriting, or do these expenses also die off at six months or nine months, or so?

MR. BAXTER: When talking about expenses dying off, I was talking more in terms of a continuance table basis. They may not dwindle for a particular case, and in fact, expenses tend to run full steam while the client is involved in the business and then drop off as he is no longer involved. So, they die out as many clients start out and drop off. What we have seen in the professional markets is, yes, it is possible for these to continue for a long period of time, but mostly, the other partners are pushing for a

solution within six months or so. That is, if there are four partners, and one is disabled, the other three are pushing pretty hard for some solution to the problem because they are carrying the load, and they don't like it. Again, this convinces me that the buyout need is there. And, one way or another, most partners are being moved out of the practice. Now, again, as the size increases, if you have 20 partners, it is a lot easier for 20 to carry one than it is for three to carry one. So, it becomes less appropriate and more difficult to underwrite the larger a case gets. We use about six lives as about as high as we like to go before getting squeamish.

MR. JEFFREY G. STEVENSON: I am going back a little bit to an earlier presentation. You mentioned the employer-pay-all type market, and the fact that you do write generally more disability insurance for an employer-pay situation. Then, you went on to say that the employer could structure this so that he wasn't taking a deduction. And, instead, when he started getting the benefits, he could pay twice as much in a 50% bracket to the employee. In this type of situation, would you write less insurance up front?

MR. BAXTER: We are starting to ask this question. I don't believe we have changed our application yet, but we are starting to ask the question in a different way, which is basically, are you getting a tax deduction for the premiums? And so, yes. In that situation we catch it and we treat it as an employee-pay plan.

MR. PARKER: I have a client that is doing essentially the same thing, trying to determine exactly who is paying the premium and whether it is legitimate or whether there is some fakery going on.

MR. BAXTER: It is not a perfect science at all.

MR. STEVENSON: Definitely not. I was going to say, that I for one am concerned that we are really under-valuing the significance of over-insurance and the over-insurance risk. I am very concerned about the employer-pay-all situation and the fact that we are writing non-cancellable contracts. And, you can write an employer-pay-all, have the employer pay, and certainly have the employee own the contract. And, they could change the premium payor from employer to employee, and be beyond the control of the insurance company. Does any of the panel have a comment on that particular problem and how you might deal with it? Or, if you see it is a problem, do any of you have experience that it has happened?

MR. PARKER: I can only speak in terms of having seen a good many of these cases written, and I haven't seen the problem arise. To me, it is more theoretical than real. One of the things you have to remember is that employers buy this because there is a good tax reason to do so, and because they want to protect their employees. They don't buy it unless they have the funds. A company, a group, or a partnership that's just barely scraping by is not going to buy one of these plans. They have to be doing well. It's like a pension plan, they have to be doing well or they are not going to buy it. So, you have probably a minimal motivation to cheat. I guess that's probably the biggest protection we have.

MR. MARX: Any further questions?

MR. PARKER: A couple things that I noted as we were going along. Dave was talking about the possibility of whether the group approach or the individual policy approach was really best. It is interesting to see the variety of approaches, and it often turns on what the salesman feels like. I have seen a case written with individual non-cancellable policies with over a 100 lives, and I have also seen group cases with three or four. At least one company I know was writing group policies on a non-cancellable basis. A big attraction for the individual policy, of course, is portability where the employee is concerned. But, the employer doesn't care unless it is two brothers or something of that sort. Another point worth making on the buyout is the retirement risk. When the number one individual is getting within four or five years of retirement, it could be a pretty fair temptation to accomplish his getting out of the business, and his selling it, by getting disabled. I think it pretty important that your policies be structured so that the benefits tail-off, somewhere around age 60. One other comment. I think a company with no experience and exposure in 4A risks is pretty wild and crazy to be trying to get into the business insurance market with the buyout. They are not going to get any business.