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PROFITABLE MANAGEMENT OF INDIVIDUAL DISABILITY LINES OF BUSINESS

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How have different individual disability lines of business (stock versus mutual, large versus small) tried to improve their profitability?

- Profitability expectations
- Key factors affecting profitability
- Recent changes to improve profitability and most difficult obstacles
- Key management information systems (MIS) needs

MR. ROBERT W. BEAL: The period of time from the mid-1980s to the present has not been kind to the individual disability insurance business. Problems created from liberal contracts, rate competition and aggressive underwriting have been compounded by such external factors as the economic recession and AIDS. Many companies that are still selling individual disability are wondering whether the line will ever be profitable again. This market is in a competitive shake-up period. Some companies that once were active individual disability competitors have already decided that the investment necessary to restore and maintain future profitability is too great and inconsistent with their strategic direction. They have sought private label or co-marketing agreements with individual disability specialist companies. Many other companies are now going through the same strategic exercise. If they decide to continue to manufacture their own individual disability products, then they must have a clear set of action steps necessary to bring the line back to the black.

The purpose of this panel is to look at a number of ways in which some of the companies are attacking the individual disability profitability question. Panel members here represent a variety of companies from stock and mutual to different size blocks of individual disability business. All companies represented on the panel have been active long-time individual disability competitors. But each one should have a unique perspective on the problem and may be emphasizing different aspects of it. At the end of the session, I hope you will have heard some valuable ideas that are applicable to your own company's situation.

The first speaker will be Chuck Waldron who is the individual health actuary at Mutual of New York. The 1990 earned premium for his individual disability line of business was $60 million compared to the total company premium of about $1 billion. Next will be Tom Bell who is chief actuary at Massachusetts Casualty, which had about $33 million of earned premium in 1990. By the way, Massachusetts Casualty is one of the few companies that is solely dedicated to the individual disability business. Tom will be followed by Jeff Bell who is director of individual disability marketing at Northwestern Mutual. His line brought in about $220 million last year of earned

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premium, compared to the total company premium revenue of $4 billion. I mention the premium figures here to give you some idea of the relative size of the individual disability businesses represented, within their own companies as well as within the individual disability market. Both types of relative size could have some bearing on the problems and the solutions facing each company.

MR. CHARLES M. WALDRON: I intend to talk a little bit about how I look at the profitability of the disability income line. In my company, the disability income line gets lost in the rounding and often is ignored until problems crop up. And then all of a sudden the problems are major and you need to work at them. In the course of the discussion about how we measure profitability, I hope to be able to cover some of the key factors that I look at and some of the things we're trying to do to fix the line up. I'll also discuss the informational needs that we have.

As Bob pointed out, we're a fairly small line in a major life insurance company. Our profitability is subject to a great deal of fluctuation just because of our size. The first step in any kind of profitability is to talk about how you're going to measure it. There are all kinds of ways to measure profit, and you all are probably very familiar with them. There are measures for statutory, GAAP, and tax. Also you might measure on a marginal basis, value-added basis or your own original basis. I presume you've all enumerated the pros and cons of most of those approaches at one time or another. Somebody probably asked that question and sent it to the Examination Committee. I'm not going to dwell on that particular subject. I think you all understand that. I'm just going to talk about what I look at for the disability income line.

I measure profitability on a marginal basis. I do use basic statutory accounting. I want to make sure at Mutual of New York that the disability income line is covering its direct expenses -- those that are charged directly to the line. These would be your commissions, your overrides, your bonuses, your underwriting costs, your policyholder service costs. If I can identify them directly and notice they're directly charged, I include the systems costs for the direct operations. I'm hoping to shoot on this particular measure for something around 20-25% of premium as a profit. That gives me a measure, I think, large enough to warrant the risk that the company is assuming and still make it a worthwhile and profitable line.

The other reason for looking at profit marginally is that it contains only those the disability income line factors which management has control over. In Mutual of New York, and probably in any large mutual life insurance company where disability income is the small player, the overhead and the allocated expenses will be enormous. The line gets lost in the rounding, as they say, and it's very easy to get a lot of expenses piled on in a hurry. These expenses, on a true statutory basis, will take the line into a negative position which is virtually impossible to get out of unless the company is extremely efficient. MONY, in fact, did review this marginal approach just recently. We took a serious look at a disability income line to see if it was still going to meet our strategic direction. I believe that in looking at it from the marginal angle that MONY determined that the line was valuable but that we needed to improve its profitability, because as I mentioned, we're not quite getting the 20-25% these days. MONY, in fact, for all of its product lines, still looks at statutory and GAAP accounting and tries to hold the line management accountable for both. A danger in this kind of company is you could easily run into having goals set on a GAAP and statutory basis which are inconsistent. One could be forced into declining sales in order to meet them. For example, if you have pricing goals that are measured on a GAAP basis, you might be able to go out and sell like gangbusters, but your statutory accounting, when you take into account some of the antiselection that occurs in this field, will only aggravate your surplus strain and you get into a position that's virtually impossible to meet both objectives.

It's not too unreasonable in this kind of company, though, to find multiple accounting bases with multiple goals. What you have to do is make sure that all your goals are consistent. That usually requires an education process. For example on this marginal basis that I mentioned, overhead expenses wouldn't be involved. But they are important, and you don't want to lose track of those numbers. In a company like Mutual of New York, you've got an expense allocation process that is highly sophisticated. Trying to track through that expense allocation process to find any of the inconsistencies, or inaccuracies, as I prefer to call them, is probably impossible to do. There are so many allocation ratios. I think a person said there is somewhere in the neighborhood of 10,000 ratios that are used in the allocation process. Trying to go through and find out what's going on, puts you in a quagmire you're never going to be able to get out of. But overhead expenses are still important, and the disability income line management has to get a handle on them and keep them down. Overhead clearly has an effect on the net investment income allocation, and that does affect this marginal measure that I look at. So you must be on top of it. In a former company, I was talking with a life pricing actuary one time about this problem. He had a little bit of trouble with expenses also, but he couldn't understand why I would be complaining about 2% or 3% inaccuracy in the allocation of the expenses. But at Mutual of New York, that could mount to somewhere between $7-10 million. And for a $60 million block of business, that's a rather significant expense variation.

When you think about this sophisticated allocation process at Mutual of New York, it really boils down to the employees estimating their time. So the allocation relies solely on a guess. No company requires all their employees to fill out time sheets on a daily basis. Maybe in consulting one has to do that, but insurance companies haven't figured that one out yet. A person might sit down and in one hour determine what he did for the health insurance line all year. We all know he's just going to guess. In reality, it might be just 3% of his time spent on disability income, but he's going to put down 5 or 10% because that seems like a small number to him. And when it gets all wound up through the allocation process, you could easily be looking at some major expense inaccuracies that you're really never going to find. You may have to follow the people who do the cost accounting and the allocations around the company and then sit down and talk to the people as they're filling out the survey and educate them on how important their allocation really is.

Another key factor that Mutual of New York has settled on, at least in our disability income management operation, is what I call a concept of education. I would think at any large mutual life insurance company, most everyone, from senior management right on down to the newest hired mail clerk and the new agents is quite familiar with and understands life insurance. In life insurance the policyholder is either dead or alive. It's a simple concept to grasp. And the dynamics of the financials are well understood by your management. These people generally find the disability income products, their dynamics and their financials to be rather complicated. It's a foreign concept to them. That same pricing actuary I was talking to at another company never could understand why, if we underwrite the business, our underwriting selection factors were greater than one. The answer is underwriting helps a great deal, but it's still antiselection business when you get done. He was having a little trouble with that concept. The life insurance thinking understands antiselection and surplus drain. But the fact that your claim experience actually aggravates rather than mitigates that is a problem I have found to be a difficult pill to swallow for these people.

The other piece is education for the management information needs of the product line. You're usually going to have to collect information that's quite foreign to the life insurance person. Claims experience by producer wouldn't occur to the life insurance side of the house. Time service studies are usually there, but they help you in educating these people. I've often been asked by my management to keep giving the life insurance analogy to what I'm trying to explain on disability income. Quite often there is no analogy. MONY's disability income management believes that education is the real key to the profitable management of our line. We're constantly educating our senior management, middle management and other areas of the company on the differences between disability income and life insurance. Eventually it starts to sink in. You no longer hear them say, "Yeah, it's like life insurance. It does this." Instead what you hear is, "Yeah, it's a lot like casualty insurance." We're explaining why it's not casualty insurance, one of the key differences being you can't change the premiums. While we have claim cycles like casualty insurance, our cycles are going to be much longer because we can't go back and change the premiums on the in-force business.

With the field, we believe that the education concept is again going to be one of the major items. We've actually changed our thinking over time. We used to do what I'd call a separate but equal education process. We'd like to run our own training sessions and develop our own product materials, have our own marketing department, have our own seminars and all kinds of things to educate the field. We would send our people out constantly on agency visits, educating the field agents how to sell disability income, and why it is important that they do their field underwriting. In fact, we even call them field underwriters. We thought it would be nice to explain to them why they're called that and why it's important that they get the information accurate and complete and give us as much about the person as possible. MONY's disability income management now thinks that, while it's been somewhat successful for us, the separate but equal process doesn't really cut it and that we need to be a little more integrated with our life insurance process. Visibility now becomes a big concern. We find ourselves never being on the program. The company has a meeting and you'll see all kinds of life insurance. We have a magazine for the field agents. It's rare you'll see a disability income article in the magazine. The result of a separate but equal philosophy is that's changing now and we're trying to provide equal billing. The object is to get visibility in front of the field, explain that we have the product, explain why it's there, how good it is, and include disability income throughout our articles and conventions -- giving it equal billing or as close to equal billing as one can, given that we're less than 1% of total revenues -- will improve production. And that, of course, requires some education of the people who set up those meetings. They have to remember we actually do have a disability income operation.

One area that we spend a great deal of time on is explaining the differences in underwriting. It seems to always occur. We're convinced that you could never underwrite disability insurance to the same time frame as life insurance. And our field is convinced that you can. No matter what kind of explanations we give the agents, the time frame seems to be very difficult for them to accept. So we're spending a great deal of time and effort explaining the differences and the risk. That's the same kind of education process for management. It's also what we would use for training. The risk is different; the underwriting must be different.

Underwriting leads me to the third key area: clearly you want to control and manage your claims experience to the best of your ability. We continue to think that is clearly a key factor. It's also an obvious one. If you can have less claims, you make more money. That's the theory. But usually it has to be done in an indirect manner. We think MONY has done pretty well at this over the years. We continue to refine this process. If you look at our financial history and just look at our loss ratios over the last twenty years, I think we have outperformed the industry average in nearly every one of those years. I think it was 1983 we failed to outperform the industry average, but for every other year one back through at least 1975, we had a lower loss ratio. So we think we do claim control pretty well, and we think we do it through an indirect management of that process.

So what do I mean by an indirect management of the process? I guess maybe I ought to tell you what I mean by direct, and that will give you an indication of where I'm going. A direct method would clearly be your claims procedure. When do you pay the benefits, what documentation do you obtain, should you travel and visit the person face to face, should you negotiate a settlement? All of those kinds of operations are good tools for directly managing your claim experience. And they have a dramatic short-term effect on your claim experience. You can really make the numbers move around. I can change my results by $4 or $5 million by changing some of those processes. But they're short-term solutions. I mean, they're all good things to do, and you should start doing some of these kinds of things. But over the long haul, their relative effectiveness is going to be diminished. It's really going to be the indirect methods that are going to be your ultimate profitability tools. One such thing is your underwriting. Some people might argue that's direct. I think it's really indirect. You're setting up procedures for selecting the risks, but you're not directly controlling that claim.

I'll probably come back to underwriting, but another form of indirect management that I want to talk about first, because at Mutual of New York we think it's pretty important, is the contract language. Mutual of New York, since about the mid-1970s, has been trying to write the clear, concise, and very comprehensive contract. If you read it, you'll find some of our provisions have rather elaborate explanations. We've even had regulators ask us why when they say our competitors only have about one or two sentences. Apparently some time back in the 1970s, Mutual of New York stumbled upon a correlation of quality claims results with a rather thorough contract. I think it came out of the claims department. It seems to make some sense to us that if you have a clear, concise contract, you know what you're going to pay, and the likelihood of manipulation should be less. I'm not sure it's totally valid in today's marketplace, but I think our claims experience over these years certainly doesn't dispute that it seems to work. There's some correlation. We also think that as a side benefit to having this precise contract language, it gives us a slight competitive advantage. We all know that the insurance agent has a rather low image from the public. We usually find our agents are in competition with a client that they don't know. And that client probably does not know the other insurance agent in competition. So he can use to his advantage the image that insurance agents have. He can sit there and say, "Okay, so we're not highly regarded by you. But we have a contract that's pretty clear. And this guy's contract over here is somewhat less clear. And if you don't trust any insurance companies, then maybe you want to work with a company that is dedicated toward trying to explain what will happen right up front." That may not work any more, but we think it has worked pretty well so far. Obviously the other side of that coin is that the client is less able to manipulate a detailed contract in order to collect benefits. We have not seen that to be the preponderance of the problem.

To get back to underwriting, Mutual of New York strongly believes in a strong technical underwriting department dedicated to the disability income risk. Our disability underwriters do not do any life insurance, and we have no intention of them doing that. There's lots of reasons why and part of it even goes to the education process. It took us a while to educate management that disability underwriting was so much different and required a different type of person than one who underwrites life insurance. We have built what we think to be a very fine staff of underwriters. Clearly, we have to educate -- again, going back to the education process --management as to why this has to happen, and we continue to do so. Management comes and goes, but disability income remains the same. Disability income underwriting requires more than just developing the insurance profile of the health of the insured. We have to be worried about the financial profile of the insured, his family, his business, his industry, probably his neighbors, too, for all I know. And that is something that's again rather foreign to the life insurance operation. We also are now trying to get what I call a psychological profile of the person. This profile is driven by the mental and nervous claim experience that the industry -- and Mutual of New York is no exception -- is having. It's becoming our number one cause of disability. What we're trying to do through what we call our personal history telephone interviews -- there's nothing really on the application -- is to determine the person's work ethics. We're trying to determine how the person handles stress. And I would call it toying or playing around, but we're asking different kinds of questions to see if we can elicit some kind of response that might tell us something. We're hoping through this process that we're going to be able to find and select a better risk.

As you can see, our underwriting department, we think, is a key item. We try to keep it staffed with strong and effective people. We do an awful lot of training of these people, and we're constantly monitoring what we can do better. We do that through our claims experience, which leads me to a third key factor on managing your claim experience, and that is management information. In disability income, you've got to have all kinds of information. Many of you are probably aware of that. The systems developed can be very sophisticated and quite expensive. MONY has a middle of the road approach, and we're constantly spending money to improve it. The advantage of it from our point of view is that we know exactly where we make or lose money. We have special sales programs on occasion. We had one back in 1987 where we did somewhat of a guarantee issue business on existing policyholders. We were able to track that experience, and we do so on a quarterly basis.

We keep an eye on its profitability. We wrote about $4 million of that business, and as you would expect, the experience in that is not as good as the stuff we underwrote at the same time. My underwriters were very pleased to hear that. But the expense of systems development can be a real serious stumbling block for many companies. Fortunately, you can always do it by hand. The smaller you are, the easier the job is, I think. Our field force is constantly challenging us to make sure that Mutual of New York's experience justifies any change. Many of our changes do mirror what the industry has been doing, but it is based on our own experience. Our experience oddly enough follows the industry, though at a better level.

What kind of information? I can enumerate a million kinds like looking at your claim experience by elimination period, benefit period, occupation, and field underwriter, as we call them, or agent. To tie back to the education piece, developing information by our field underwriters was questioned as to the expense and the relative value of it by our management. The argument was whether this information is not statistically significant for any one particular producer. My usual retort to that quickly is, "You're right. The agent has only written six policies and they all went out on claim. Do you consider that statistically significant?" I certainly do, and I'd just as soon not have that kind of business. So we do monitor all of that. We're trying to do it more often than once a year, but again the cost is rather expensive. You can also look at experience by cause of disability. Many of you are probably familiar that anything that affects the premium you clearly want to monitor. And you might even want to look at some irrelevant stuff. I'd like us to start asking the question about clear contract language to the customer because I'd like to see if it's really true that the clear contract language improves our claim experience.

Other statistics also are important. As I mentioned on the education process, you clearly want to keep track of your time service studies. Our agents are convinced it only takes us one to two hours to underwrite a life insurance policy, and it takes six months to underwrite the disability policy. And if you don't have your statistics down, how are you going to refute the information. That's their perception, and it's never going to be the same as ours. Our life side has an expert system that underwriting never has to be touched by human hands. That includes the issue. The agent submits it in the field and then bang, it gets printed. It only takes about an hour to run through the whole system. So agents really can underwrite a case in an hour. And that same case will be submitted for disability income, and even if we get it back in three weeks, it'll seem like eternity to the agents because he's been sitting on the life insurance policy for three weeks.

Another advantage to having all of this management information is it keeps your underwriting, your claims, your actuarial and your marketing forces very close together. And in our opinion, a coordinated effort is very important. You have to have everybody in sync.

The last kind of management information that I think often gets overlooked is reliable information on a competitor's actions. The source of this information is very key to us. We really want to keep track of what our competitors are doing, so we expend a great deal of effort monitoring what they do. Clearly to react to information which is erroneous could cause you serious harm. But the real purpose for Mutual of New York in keeping track and getting reliable competitive information doesn't mean that we react at all or even follow. I've drawn an analogy to football. We scout our competition very carefully, but we go out and play our own game. This is a new philosophy actually for Mutual of New York. We used to scout our competition so we could figure out what we had to do next. The large brokerage houses tended to define what we were going to do, and we now think that's a mistake because, if you're going to play your competitor's game, he's going to win. So if you want to win, you've got to play your own game. We decided to start playing our own game.

As you can see, a large mutual company has a set of unique challenges for the disability income line. The characteristics of which create, from my point of view, a very frustrating, exciting, but great opportunity for us. A disability income management team needs to have the stamina to attack the challenges with innovative solutions and pragmatic compromises in a life insurance company. Knowing how the line is measured for its profitability and how the key factors affect that profitability in our opinion are key for our management. And so we are trying to follow that process, and we are educating all the people in the disability income line as to how that works. We are now making our decisions based on that understanding.

MR. THOMAS S. BELL: When I was approached on the topic of talking about profitable management of disability income, I thought the first question is, "Is it possible?" I know a few companies do disability income and do it well. It's been a tough segment of the business for as long as I've been in the insurance business. But I think that makes it a challenge, and I hope that it makes it more fun for those of us who are in this part of the business. My main focus and my main personal interest is really in the management aspects of the product line rather than specifically the actuarial aspect although that's obviously a big part of it.

Let me start by giving a little bit of my personal background. I've been with Sun Life which is the parent company of Massachusetts Casualty, for 25 years. I spent about half my career in Canada. I'm originally from Montreal. And I've spent the other half in the U.S. I first was exposed to disability income when I was an actuarial student a long time ago. And since then, I've worked in individual product. I've worked in group insurance in Canada and the states. I've worked in small pension business. And I've only recently been in the disability income business. I moved over to Massachusetts Casualty from Sun Life in January 1991. So my viewpoints are perhaps those of someone who has a long and broad view of the insurance business, and has been observing disability income a little bit from a distance for a while. That may be good or that may be bad. I can see things that maybe those of you who are immersed in this segment of the business are too close to sometimes see. And on the other hand, I don't have the degree of detail that you have.

I'd like to talk briefly on Massachusetts Casualty, the company, just so you'll know where I'm coming from. I imagine a lot of you are from smaller companies, and it probably would be helpful if you knew a bit about our situation. Massachusetts Casualty was a family-owned company until about ten years ago at which time it was sold to Equitable of Iowa. That company held it for about five years, and Sun Life bought it in 1986. Just to give you some parameters on our size, there are about 120 people. The assets are around $125 million. Our direct premium is on the order of $45 million, and our net premium this year will be about $37 million. Like most of the industry, we lost money in 1990. We lost $8 million, which for us is a big chunk. It's about 25% of premium. Our goal this year is to cut that in half and to look onward and upward thereafter. As Bob mentioned earlier, we are a specialty company. As far as I know, Massachusetts Casualty is the only company that is 100% devoted to the individual disability income business. And as has also been said, I represent the viewpoint of the smallest company on the panel.

Next I'd like to talk very briefly about the disability income market as I see it. Our company size places us between number 15 and number 20 in size, depending on whether you go by new business or whether you go by business in force. It also depends on which players have exited the market in the recent past. But we're somewhere in the 15-20 range. We have a variety of concerns in being a small player. What is the ability of a small player to influence the market? That's a huge issue for us. Are we forced to follow? Can we lead? I personally have concerns about the growing oligopoly in the business, the market share of the top five companies is increasing as it is in almost any industry you want to look at, whether it's airlines or pharmaceutical or whatever. Maybe this is good, maybe it's bad. Michael Porter of Harvard says this is a bad move for U.S. business in general. The CEOs of the companies that are gobbling up their small competitors obviously think it's a good thing to do or presumably they wouldn't do it. The observable fact is that the market share that's being vacated by the smaller players is all going toward the bigger players. It's not being redistributed among the remaining smaller players. So a question for us and I'm sure for all the other small companies is, what is the role of the smaller player in the future?

Let me turn now to some specific issues which are certainly live issues for Massachusetts Casualty. I suspect they would be for most small companies, and some of them would be also for larger companies. We have a position on each of these, but I think it probably would be more helpful to you if you just mentally have a checklist of things to think about. Your solutions would probably be different than ours, just depending on where you find your company at the present time. I guess one first concern I had about the business when I joined Massachusetts Casualty earlier in 1991 is the fixed premium nature of the product. No one seems to have been able to find an effective way of moving the product. The need for disability income is clearly there. But not many companies have found an effective way of dealing with the fact that you're charging a fixed, essentially nonparticipating premium, and you're subject to all manner of things that happen in the marketplace. A specific example would be the Deferred Acquisition Cost (DAC) Tax which came out of nowhere. All of a sudden you've got to cough up another 2-3% of premium. And I don't know where you're supposed to get it. It's not in the premium. A second issue for us is the question of how should we position our pricing? Should we match the market? If you're a small player, do you have to be lower than market? Can you be a specialty company and charge a little more by providing a little more service? Those are issues that we have to deal with. The whole question of size is for us a very practical problem. You hear the words *critical mass*. Is that a real thing or is that a myth? I don't know. Certainly the trend is toward bigger groupings. For every negative there is a positive. The positive of being small is the flexibility. We can change direction rather quickly. Large companies can't. We're a specialty company. It gives us the advantage of focus. We don't spend any time at all deciding whether we should emphasize this product line or that product line. That's it. This is our product line. As everyone knows, the disability income business has had a tough time for the past five or six years. So to talk of profit margins at this time is somewhat academic I would think. But I know our goal is to get from minus back up to plus. And it doesn't much matter how little the plus is, as long as it's a plus.

When we're doing our pricing, we tend to express our profit margins as a return on equity although we also look at it as percentage of premium. So there's different ways to do that. And of course, permeating this whole profit issue really I guess for all sizes of companies, but certainly for us, is the question of survival in the short term. It's great to have long-term plans, but if you don't make it in the short term, the long term isn't there for you to have to worry about. And then, of course, because the products are so heavily front-end loaded, if you sell too much, you've got a surplus strain, and you really have to balance how much of what you're doing is for today and how much of what you're doing is for tomorrow.

The next topic that's of concern to us, and I won't mention it in much detail because it's very controversial, is the whole issue of the rating agencies and whether they're helping or hurting. Are they just putting a millstone around people's necks, or are they making a positive contribution? In any case, they're there and it's something we have to deal with.

We have the usual issues that all companies have regarding expenses: recurring versus non-recurring, essential expenses versus what I call deferrable expenses. The analogy that I use often is you can always wait one more year before you paint your house, but sooner or later you have to paint your house. And there's expenses of that type that you can defer in the short term, but they kind of catch up with you and you have to deal with them.

One of the attributes of being a stand-alone company devoted entirely to one product line is that we don't have any corporate allocation of overhead which all of you have, as I know having worked for Sun Life and fought the battles of allocations of expenses for various product lines for years. We don't spend any time having to grapple with corporate allocations. There's just the 120 of us and that's it. We not only don't get any corporate allocations, but also we don't have to spend time talking about it. When I think back on the hours and the battles of every product line trying to prove that it's getting gypped and the other guy is getting a free ride or at least a half-price ride, we just don't have to deal with that. That's a plus for us.

The question of sales is not a problem for us. If anything, we're in a mode of trying to control sales because of the front-end load of expenses as well as our administrative ability to handle all the business. So sales within reason don't seem to really be a problem. In regard to underwriting, I guess we're facing the same issues that the industry is. There seems to be a trend toward tighter financial underwriting for a variety of reasons. Companies are grappling with what to do about people who test HIV positive, medical practitioners doing basic procedures and all of that sort of thing, and one by one the different companies are coming out with their positions. Some of them are hardline, some of them are saying guess we have to pay, and different shades in between. Our company is focusing more on the geographical underwriting. We're always having a look at occupations and shifting people from one group to another and things of this sort. I guess we're going through a lot of thought about whether the so-called upper occupation groups -- the groups that traditionally have been considered to be attractive. Are they, in fact, attractive? And what about the rest of the market?

In the area of product features, viewing the market from outside as I was until recently, it appeared that the marketplace was being overly market driven and that each company that came out with a liberalization was being followed by its competitors down a path that may not have been wise. The product line seems to have gotten pretty far away from its roots as an income replacement business. But it's encouraging to see that there's a lot of tightening up in product wording these days.

Like larger companies, we also do financial projections. We do five-year projections of our income statement of our balance sheet. We'll be getting into cash-flow testing. Because we're owned by Sun Life of Canada, which is a Canadian-based company, we will be getting into dynamic solvency testing, which means you have to test a bunch of scenarios. So we do a lot of "what if" testing: what if we doubled our sales, what if we halved our sales, and so on. I suppose for any size company but more so perhaps for a small company, reinsurance is an issue we have to deal with. We have to decide how much, what carrier, what type of reinsurance, and that sort of thing.

As has been mentioned already, claim management is a huge part of what this business is all about. Like other companies, we grapple with, should you centralize your claims operations, should you decentralize your claim operations, how sophisticated should your computer systems be, is the money well spent, what should your settlement philosophy be, are you doing the person a favor, are you being too paternalistic if you refuse to settle, and a whole bunch of issues there that you all know. Our position is we want to be fair and we want to be firm. So we want to pay those just claims and not get jerked around by people who are trying to take advantage of us.

In the area of MIS, like any other product line, you need accurate, timely, well-organized information. We're doing a lot of work on that. One of the areas our company really needs to bolster is our ability to come up with timely analyses. And as has been mentioned by Chuck, you have to be able to split it by this way and that way and the other way in a zillion different ways. And you have to be able to come up with ad hoc, nonrecurring requests that won't be given low priority so that eight months from now maybe you'll get the thing done. You've got to have the ability to talk to the MIS people and get a report in a couple of days. We have a pretty good way of doing that.

Ultimately, service I think is what's going to differentiate Massachusetts Casualty or any other company from the other ones. The product line frankly is, at least so far, a commodity business, but it's a very homogeneous product that people are selling. Any company that has access to a copier machine can go out and find out what its competitors are doing. And tomorrow your choice is, do I want to do the same or not? But you don't have to spend months and months and months of research. It's very easy to stay up there.

And the final issue we have as a wholly owned subsidiary of a large company is the question of, how do we get the most leverage out of our parent? How do we best utilize the fact that we're owned by Sun Life of Canada, which is a multinational company? Some of the ways they help us is we get about a quarter of our sales through their agency force. They help us with financing. They help us with training. And probably most important, they help us with respect to the solvency issues and just in terms of general credibility. We're perceived to be a much bigger player in the marketplace than we would be if we were totally stand-alone.

Let me sum up by discussing some of the recent changes that have been made to improve profitability. Prices have gone up. I think pretty well every company has raised its prices. The trend away from 30-day business seems to be pretty solid. I've mentioned some of the other ones: contractual tightening, underwriting financial and occupational, claims, MIS, and so on. One final issue that we've had to deal with is monitoring the industry. We keep pretty close tabs on what the major companies are doing. They are the ones that either through action or inaction set the pace for the rest of us. So we monitor them totally. We don't necessarily follow them. We follow selectively, but we monitor 100%. And then the issue I mentioned earlier, the question of the ability of the small company to influence the market and the risks of deviating presents a dilemma. You may come out with a well-priced, very thoughtful product, but if a customer can buy it more cheaply elsewhere, you have a tough marketing issue to grapple with.

In summary, we feel we're on top of the various issues that are confronting us. Our goal is to become a high-quality, profitable, growing specialty company. And we're on track to doing that. We believe we can profitably manage the disability income product line.

MR. JEFFREY J. BELL: I am not for a moment going to sit up here and try to sound like an actuary. I represent the large mutual company. Knock on wood, we're profitable in disability income. So I hope that holds. In terms of measuring profitability, we have profit targets. At Northwestern, we're not profit driven. We're a large mutual company. We have profit targets, but we don't live and die by that profit sword. But we do have targets. And one of the things that has come out of that is that it's made us very aware of the kind of business that we write.

Now in terms of MIS needs, I think that systems needs are almost like a large umbrella. It doesn't really matter to me if you're a large company or a small company. You're going to have systems requirements. You're going to have the need to study the data that presents itself. And I think in a small company as Tom was mentioning, part of the issue there may be whether you have the systems to get it done. In a large company, it's the same issue. We write a fair amount of disability premium. Another way to measure it is we're about 20% of our agent's first-year commission. So that starts to get their attention. But by no means do we have carte blanche. We're in there fighting like cats and dogs trying to get systems resources to have studies done. Now one of the things that occurred over the last year that has had a noticeable impact on how we're doing business is that we are finally able to have some very segmented studies done on our experience. We were able to take a look at the kind of business that we've written and how profitable that business was, and literally slice it about as fine as you want. I can go to the actuarial area and say I'm interested in a profitability study on this particular occupation, and those people can give it to me. Now that has definitely impacted pricing decisions that we've made. I really feel that's going to be an area that's going to have continued focus. And I really think, from the larger company perspective, you're going to have to have that information. So that's something we're putting a lot of focus on. We want to know the kind of business that's being placed on the books and how good that particular business is.

Now the other thing that helps us is we have a unique situation in terms of the partnership that exists at the Northwestern between the home office and the field. I was with UNUM for six and a half years. I was responsible for its individual disability brokerage operations in the northwest, so I am not a person who was raised in the Northwestern Mutual culture. If you were to slice my arm, a portion of the blood would be blue now, but not the entire amount. I don't know that what we're doing necessarily can be copied because you really can't underestimate the team play that exists. Now if you have that in your organization, I think that's fabulous. If you don't, I think that's something that certainly could be strived toward. Because everything I talked about so far the field is involved in. I mean, the field by no means runs the company. But the field is certainly aware of all of the issues that are taking place that will have a major impact on us. The people in the field like the idea of loss ratio studies because the first step in these loss ratio studies is to take a look at your entire block, segment it out and say, "Okay, here's where it's profitable, here's where it isn't." From a marketing perspective, one of the reasons that I really wanted these kinds of studies is because I like to be able to target profitable market niches of business. Now you have to picture this. You're sitting around a table. The marketer comes forward and says, "You know, I'd really like to have this because in my mind I'm visualizing two, three, four, five key occupation classes. We'd really like to go after them, really be extremely competitive." But the downside is we may uncover occupation classes where, although we're competitive today, we won't be once the studies come forth. Because you may find that those areas that you were competitive in, you're not going to be because the claims experience isn't good. And so you walk into that with the understanding that, sure, there's a lot of potential pluses at the end, but they might not materialize. But I still remain very enthusiastic because of some of the early information that's coming out. I think you have to understand that it's a balancing act. You're going to have some occupations that are real good, some that aren't. You have to pay the price. And a little bit later, I want to talk about basically what marketing can do for actuarial and vice versa. I think that's just part of the ponying up if you will, saying, "Okay, we know that some may go up, some may go down. But that's part of the deal."

Tied into that concept is a fact that I really think needs to be stressed: there is no free lunch any more. If marketing had come forward in the 1980s, and I can remember being in the field and beating on Bob's head or the home office's head saying, "We're out of business if I don't have this particular rider or this particular option." It's like I have got to have lifetime renewability. I mean, I'm out of business if you don't give me lifetime renewability. I'm toast. It's done. It's all over. And so, (we don't have lifetime renewability, by the way) life does go on. But the marketing area has got to understand that you can't keep asking because there's a cost associated with the request. We've all seen what the claims experience has done. The field has to know why we're doing something this way or why we're not doing it that way any longer and studies will support this, and what I have found is that, if you could provide information to the field, those people will support you. Because if they don't, where's the line going to be? There isn't going to be one. I think it's fairly black and white there.

From a claims standpoint, I guess about three years ago the Northwestern introduced an agent's claim monitoring program that became legendary based on some of the calls that I have gotten. I got a call from one of our competitors who said, "I understand that you terminated 30% of your agents due to bad claim experience." I said, "I know marketing is in a different building, but it seems to me if we had just terminated 2,100 agents, I would have heard about that." I'm out of the office so maybe that's going on now. But anyway, we sat down and said, we need to take some steps to insure the profitability of the line. Part of those steps is to take a look at the claims experience that we have on particular agents. So we designed a claims management program that had three levels. What I refer to as the good, the bad and the ugly. You have level one which was claims experience that was way above company average. Level two was above but not necessarily enough to cause real alarms. And level three was simply claims experience above company average that could be bad luck. It was set up to take a look at life years exposed, cash loss ratios, number of lives on claim, etc. All of that was pulled together. We found the program to be very well-received by the field because frankly, we don't have very many agents involved in it. I have to tell you, though, the initial reaction by the field was, "Why are we doing this?" So we explained to them what we're trying to do in terms of the long term and controlling the overall health of the line. And when the agents understood that, the field -- and I'm talking about the general agents, the district agents and special agents -- all bought into the program. We have not had any problems, and it's been a very positive experience overall.

The focus of the program is to have the agents try to change selling habits if they need to be changed away from a feature-driven sale more to a needs base and to understand the kind of business they're writing. Also, to drive home responsibility for the business being written to the field. We want the general agents and the district agents to understand the kind of business that's being written in their agencies and how it impacts the overall profitability of the line. That's what we're doing and it's actually working out really well. It's a fairly expensive program. It took a fair number of resources to be implemented. And it's in its third year. So it's been around for a while. We continue to change it a little bit each year. We continue to get field input on the changes. And it's put a lot of focus on making sure that you're looking at quality business.

Basically our expense philosophy is we don't pay for anything. That's plain and simple. The next time you're at your convention down at Hilton Head or San Diego or Hawaii, think about the week of July 21 in Milwaukee, Wisconsin. Because that's where the agents pay their own way to come to the NML convention. I pay my own way. Now granted, I just have to drive down the street, but I have to pay to get in. So expense control permeates the entire organization. I think it's great. I mean, from an efficiency standpoint, the disability marketing area is a small group at the Northwestern. I have four folks who report to me to market a line that this year will be $260-270 million. That's a very small portion of the company in terms of people. Obviously I'd like to have some more people. I go up to my boss and say, "Dick, I'd like to have some more people." It's a very short conversation. We go onto something else. But I get this notice that says, "Jeff, you have some 312 people who are responsible or touch disability at the Northwestern." I was just crazed. You have to be kidding me. Because that's the person who says I'm responsible for 6% so I'll round up maybe 20%. I mean, the lady comes in. She sits down. She starts asking these questions and I'm thinking, "I wonder if my raise is tied to this? Why are you asking this? Just what do you do for a living?" And if I'm reacting that way, I have to wonder if everybody else is reacting that way. So that's one of my projects going forward this next year to try to get my arms around if you will, how many people are working on disability income. It's definitely tied to expense control.

The culture at Northwestern is to really try to increase agent productivity. You can write a lot of business, but first off, the business has to be quality business. Nobody will disagree with that fact. But the other thing you have to do is decide where that business is going to come from. Now those of us in the home office can certainly impact the kind of business being written. But the business is still being written by those folks out on the street. So what has gone on for a number of years at the Northwestern is to make sure that it is drilled into the agents' heads from birth. (When I say from birth, I mean, from signing licensing contracts with Northwestern.) Northwestern has the need to sell disability insurance. Northwestern is an individual life, individual disability income, individual annuities company. Plain and simple, that's what we do over and over and over. Now because of that, 90% of our agents write disability income. We have approximately 7,000 agents; 90% of them write disability income. As important as that number is, one that strikes me of equal importance is the fact that 85% of the agents with less than three years experience in the business cross-sell life and disability income. And the percentage of agents with three or more years in the business who cross-sell is 89 or 90%. So there's a trend. That's pretty amazing.

What it does is it makes our job a lot easier. But what it also does is it challenges us to make sure that we put in appropriate training on the street for the agents to continue that kind of trend. We have an informal disability income coordinator program. Out of 106 general agencies, there might be 50 coordinators. The disability income coordinator is the person who is the individual in the agency who is the local disability income guru, who knows how to do it, knows how to answer all the questions, and does joint work. He is also responsible for training. The training materials that we've developed in the last two years is at the request of the field. The thing that's interesting about the numbers that are being sold is there is still a great deal of discrepancy in the type of training as in the amount of time allocated for training across the country for the Northwestern. You might have an agency that spends an hour in initial training, which is the two or three week first period time training disability income. And you might have an agency that spends two days. But one of the general agents came in and said, "I'd like a four hour disability income training program to give my agents everything they need to know to hit the street and sell disability income." I said, "Okay, that sounds like a reasonable concept. I don't know if the four hour period of time is going to work." But what came out of that was what we refer to as a disability income curriculum that takes the NML agent from day one in the business through his first year. There are I believe eight or nine modules. The concept is to say, here is this modular training program that anybody can pull off the shelf. So all the script is there. You may have seen some of the Disability Insurance Training Council (DITC) or Life Underwriters Training Council

(LUTC) training courses. They're similar in nature. But the long and the short of it is that the courses were designed to go anywhere from 45 minutes to an hour and a half, to have agents come in to be able to be self-trained, to have agents be trained by a group leader, to focus on where they should be in a particular period of time in their training, to make sure that we continue to get disability income training out, to continue to focus on the need to discuss disability income with their clients, and to continue to focus on the need to write quality business.

We have also taken those agents in the company, who are very successful at selling disability income, and brought them to the forefront. They're part of the training material. The agents don't want to hear from me. I mean, they do hear from me, but they want to hear from the agents who are very successful. So we've done programs around that. Again, I would suggest that those of you in brokerage can do a similar thing. I mean, you can have training set up on the brokerage side of the house, especially in continuing education states. I know one of the things that we did was we put together continuing education credits and brought people in for seminars. Those of you on the career agency side can develop a similar program. All it takes is a little bit of time to sit down and say, "What do we want our agents to learn?" If you're not telling the agent what's important, where are they going to pick it up? So I think that there's an expense issue because you have to have it done. But I really feel that's an important part of the overall puzzle.

I'll just hit claims briefly. A great deal of focus, as I mentioned earlier, has been placed on the agent's claim system. But in our claims area, we're putting in the first phase of a claim system in terms of a processing system. We have added an additional CPA; so we now have two CPAs in the claims area. They have access to all of our medical directors for any of the mental and nervous and independent exams that come in for interpretation. When I talked to our head claims person, I said, "What's really important to you in terms of impacting profitability of disability income?" One of the first things that came out of Greg's mouth was quality people. He said it's absolutely critical to make sure that you have well-trained, topnotch people in place and that the claims are seen by those people as quickly as possible. Over the last year or year and a half, we focused a lot on early intervention. We have the claim people look at the claims right away. We have initiated a field claims representative. I believe we have two folks in place right now and have the desire to have several more than that. It's just a matter of finding good people to fill those roles. And we found that, again, understanding our culture, it's important to have a person who is from Northwestern out there talking to the clients. So early intervention, claims sys ɔpnotch people and field claims representatives are all part of the equation.

I do have some concerns about the competitors. I think Tom was mentioning that earlier. I really think that we're going to end up with a handful of companies that are writing disability income. And frankly, I'd like to see more. I think the more competition the better. I also understand that the smaller companies have some real issues to deal with because size is important, certainly for generating enough resources to get the things done that we need to get done. I don't think you can manage this business off the back of a napkin any longer. I guess in closing, in terms of what can marketing do for actuarial and what can actuarial do for marketing, I really think that my brethren in the marketing ranks need to wake up. I think they need to realize that the feature battle is dead. Now, as soon as I say that, somebody is going to come up with this new product that's to end all. But I really think that you've got to understand that everything we've asked for in the 1980s had a cost associated with it. You just can't shove the cost aside because you can shove it aside only so long. Now the lions have roared and they're coming forward. So I think the marketing people have to be realistic. I think the marketing people have to take responsibility for the training that needs to be done. And I think the marketing people ought to sit back and worry about their own house and not worry so much about everybody else's. I think you need to focus on how you do business, your culture, what's important to you. We're not market driven. I mean, if one of my competitors comes out and says, "Here's what we have," well, we'll deal with it. We're not going to come out and say, "Gee, we've got to match that." I've talked to several different companies, and I think that's kind of a Renaissance that's coming about, where people realize that you've got to take care of your own shop.

I spend a lot of time with the actuaries. I think we've got a really good relationship. We understand each other. We respect each other. One of the greatest things you can do, I feel, as a group is to explain the complex financial matters in a way that the rest of us neophytes understand. I think you will set yourself aside in a remarkable way if you can sit down and explain, "This is what it really means." Don't hoard the information. Let the marketing people know early on what trends may be developing, what it looks like, if this is going to happen. Because keep in mind that the marketing people have to be able to get out to their distribution force where they can and say, "Here's what's developing." And I'll sit in front of any one of our agencies and say, "Here's what we had to do from a pricing standpoint or from a product standpoint," and do that with a lot of confidence, as long as I have the information supplied to me by the actuarial department backing it up. Our agents understand, and I believe that the field at large understands, if you're able to document why something happened. Don't just sit out there and say, "We can't do any more. We had a bad experience on that."

And in a final note, and I put this in as a plug for the Life Insurance Marketing and Research Association (LIMRA), has an executive strategies series of courses. One of them is on financial disciplines. I would recommend that you take that back to your companies and say, "Listen, this is an opportunity." LIMRA brings in the experts and offers a solid week for nonactuaries to learn what it's like, how to understand it, and gain some background. And I found the course to be an excellent experience. It's something that I would recommend that you take back to your companies and those people who might have an interest in doing that should contact LIMRA.

MR. W. DUANE KIDWELL: I have been a student of the disability income line for a great many years. Particularly I have followed the progress of all of the companies of the panel members. And they are to be commended for the experience that their companies have shown versus the industry in total. I would say, however, that I have seen a deterioration of the experience in all of your companies. However, you've been going through a very competitive situation. We understand that's part of our normal free enterprise system. And in many ways it's good. But I also heard here something that was very encouraging. I think we have bottomed out in this downward trend, and I think we're heading back in the right direction. I think the very positive attitude that was portrayed here by the panel members was most encouraging and should be encouraging to all of us as an inspiration of what lies ahead. We are coming out of this, and we are going to do all right. We're doing the right things. Instead of looking at what other people were doing in their filing and trying to undercut them, people are now starting to look at those filings and trying to do better. And I think that's very positive. I would like to ask one question of Northwestern Mutual. I'm very intrigued with that agent business, the quality profile. It's a great management tool, if it's used. Would you explain to us what rewards and punishments are associated with that in order that the tool is not just something that management looks at and tosses aside?

MR. J. BELL: There are three levels. If somebody finds himself on level one at the end of one year, he loses his ability to write Northwestern Mutual disability income business for three consecutive years. After being on level two for two years, you again lose the right to write individual disability with Northwestern for three years. Level three is simply a letter that is sent out that says, "Gee, this could be bad luck, but your experience is above normal." And that's generated some interesting responses. I've had agents call me and say, "I've gotten two letters in my career at Northwestern. One was to congratulate me for getting my CLU degree and the second letter was the one saying I'm on level three." So that does need a little bit of refinement. But actually the reason we sent it out to all the agents, and again, it's a very small percentage of the agents, is to make sure that they heard from us that there is documentation. For agents on level one and level two, the general agent needs to countersign all their disability income applications. They need to re-take one of our disability income training courses. And those on level three basically don't do anything other than be aware of the potential repercussions if you hit level two or level one.

MR. ISADORE JERMYN: I have a question for both Chuck Waldron and Jeff Bell. Both made comments about profitability. At Mutual of New York, you mentioned that you look at the profitability on marginal expense basis targeting for 20-25% of premium. The question there is, has that been accepted by management and how do you deal with the argument that not all your lines can be profitable on a marginal basis? For Jeff Bell, you mentioned that Northwestern is profitable. I didn't know how much more you can say about that, but to the extent that you can say anything, on what sort of basis do you measure it? Were the results on a marginal basis or some other basis?

MR. J. BELL: We are profitable on both the statutory and the GAAP basis. We have profitability targets. We've met them. We haven't met them every year easily, but they certainly have become more of a focus.

MR. WALDRON: I guess on the marginal measure, I'd like to point out that I look at the marginal measure to determine it, but I don't price on it. I have to cover the expenses. The allocation is an issue, and clearly if I can get the stuff allocated over the life line, then they've got a price for it. But I am required to price for it. Management doesn't look at our results on a marginal basis. Only once has management done so and that was in our detailed review. So it doesn't go much beyond myself and the disability income management people.

I have to cover those overhead expenses one of these days. We've actually got an idea of where those expenses are supposed to be. And every year they come in substantially higher than they're supposed to be. The unfortunate part about it is the corporate actuaries keep telling me it's okay to price it where they're supposed to be. The regulators also tell me that's a good idea because if I priced them where they actually were, we'd probably wouldn't be selling much. I hope that covered it. Management really doesn't accept it as a measure. But that's what I look at because I really cannot control the overhead expenses.