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INDIVIDUAL DISABILITY INCOME PRODUCT AND EXPERIENCE TRENDS AND GROUP LONG-TERM DISABILITY PRODUCT AND EXPERIENCE TRENDS

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The disability marketplace is undergoing changes of a magnitude never seen before. Attendees will learn what changes are being made and why, and what the consumers' initial response to these has been. This session should be of interest to all sections because of the dramatic magnitude of the changes in the industry.

MR. THOMAS R. CORCORAN: Most of you have seen Chart 1 before. It shows the individual noncancelable disability income profit margin, with net income as a percentage of premium. It has been published in *The Disability Newsletter* by Milliman & Robertson, Inc., in Minneapolis, MN for the past several years. I'm sharing this to refresh the memories of people who haven't seen it in a while and to give a little indication of where the numbers are heading for 1995. As you can see, the profitability is down from about 10% of premium in the early 1980s to a 15% loss in 1994. I've done an informal survey of six of the top nine companies, and they expect a rebound in 1995. The first half of 1995 is showing some improvement, although not a dramatic one. Basically, the poor results from the block of business that was written in the mid-to-late 1980s is finally becoming a smaller percentage of the total, as companies are writing new business. So the 1980 block has not improved, but it's becoming a lesser part of the problem.

In the mid-1980s, the individual noncancelable disability insurance writers were showing 15% annual sales growth and were competing by issuing higher benefit amounts and providing more liberal benefit provisions, essentially to the same markets. So their market growth came by overinsuring the markets they were used to. Since then, they have reacted and cut back benefits, and as a result, the sales growth in the last three years has been negative.

This is intended to give a perspective on the situation, and it will support my comments on consolidation within the noncancelable individual disability insurance industry. Table 1 shows the top ten noncancelable individual disability insurance writers as of 1992. It emphasizes how rapidly consolidation can occur within an industry. I am showing these 1992 numbers because I want to show how rapidly consolidation can occur within an industry, when it does occur.

Of this group, the Provident Companies discontinued its noncancelable own-occupation-to-age-65 benefits, although it continues to issue noncancelable benefits in 1995. UNUM has discontinued issuing noncancelable benefits or is in the process of discontinuing them. Equitable stopped issuing them in 1993. Connecticut Mutual has now merged with Mass Mutual. Lincoln National has cut back dramatically on them by the end of 1994,

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and I don't know if it issues new noncancelable business at this point. New York Life also stopped issuing new noncancelable business in 1995.

CHART 1
INDIVIDUAL NONCANCELABLE DISABILITY INCOME
NINE-COMPANY PROFIT MARGIN—BEFORE DIVIDENDS

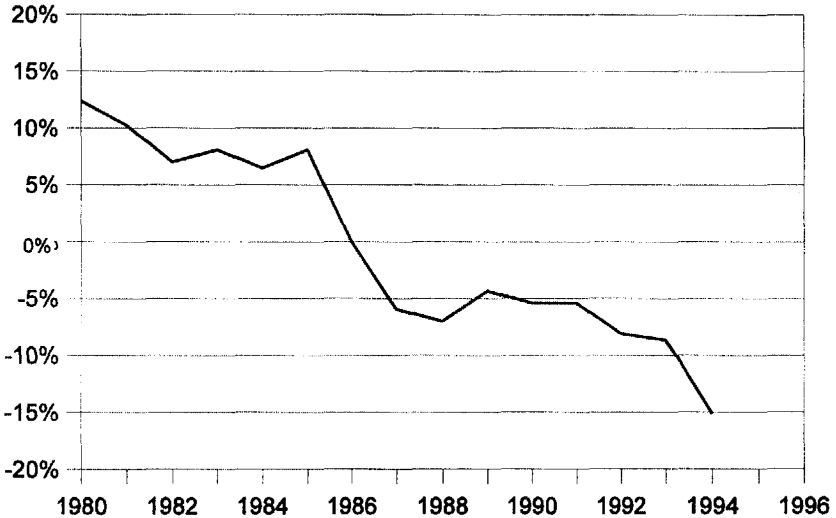


TABLE 1
TOP 10 NONCANCELABLE INDIVIDUAL
DISABILITY COMPANIES (AS OF 12/92)

	Premiums Earned (000s omitted)
Paul Revere Companies	$536,561
Provident Companies	490,090
Northwestern Mutual	279,698
UNUM Corporation	245,901
Equitable Life Assurance	144,978
Massachusetts Mutual	124,372
Connecticut Mutual	113,124
Lincoln National	85,888
New York Life	83,169
Guardian Life	66,945

Source: Data from *National Underwriter*

In just three years, five of the top ten carriers have discontinued issuing the noncancelable individual disability insurance product. Within the smaller companies, the cutback has been even greater. Some people think that the group disability insurance industry may be poised for a consolidation phase as well. This is an interesting perspective, given that when things do consolidate, they can consolidate very quickly.

MR. ALBERT A. RIGGIERI, JR.: Chart 1 probably should be relabeled as the nonprofitability chart. I think right now there needs to be more questions than answers. I hope we can expand our thinking and look at individual disability insurance a little differently than we have in the past. That's the type of thinking we need right now in the industry.

As Tom discussed, the individual disability business has had growing profitability problems for some time. At Paul Revere in 1994 and 1995, we've had a period with morbidity charges that are clearly outside of any reasonable expectations that we had. In the past, when our morbidity charges have elevated, we would take certain corrective actions, move along a slightly different track, and observe experience responding. Some new lessons need to be learned, based on our recent experience. I'd like to take a look at a few areas and see what they tell us.

Chart 2 shows Paul Revere's aggregate level morbidity results for our business since 1985. The measure of morbidity experience shown here is an interest-adjusted loss ratio. This ratio is equal to benefit payments plus reserve changes, less interest earned on reserves, all divided by premium. It provides a stable measure for us to review our experience over a long period of time, if morbidity results are staying stable.

What we see in Chart 2 is a fairly stable performance through 1993, with a slight upward tilt in loss ratios. In 1987 and 1988, we observed a slight rise in morbidity costs being driven by a few key items. Physician experience showed some elevation in claim costs, which we thought was due to HMOs becoming more active and high malpractice premiums. In addition, early policy duration experience for our 1985 and 1986 issues was another area of concern.

The potential problem with that business was that overinsurance and lifestyle protection might be impacting policyholder motivation. We had some early indicators of problems here, back in the mid-to-late 1980s. As a result, we took some measures to improve underwriting and claims management.

In the late 1980s, among other changes that were made, we developed approaches to documenting income levels. We required financial documentation and signed tax forms to base good decisions in underwriting for insurable interest. We also broadened the use of blood testing, primarily driven by concerns with AIDS, but it also turned up many substance abuse problems. Since 1990, we removed rate subsidies by gender and smoking status in certain states and for certain occupations. Overall, our rate basis is stronger. We also selectively restricted some benefits such as own-occupation and lifetime coverage.

CHART 2
PAUL REVERE LIFE INSURANCE COMPANY
INTEREST-ADJUSTED LOSS RATIOS
SINCE 1985

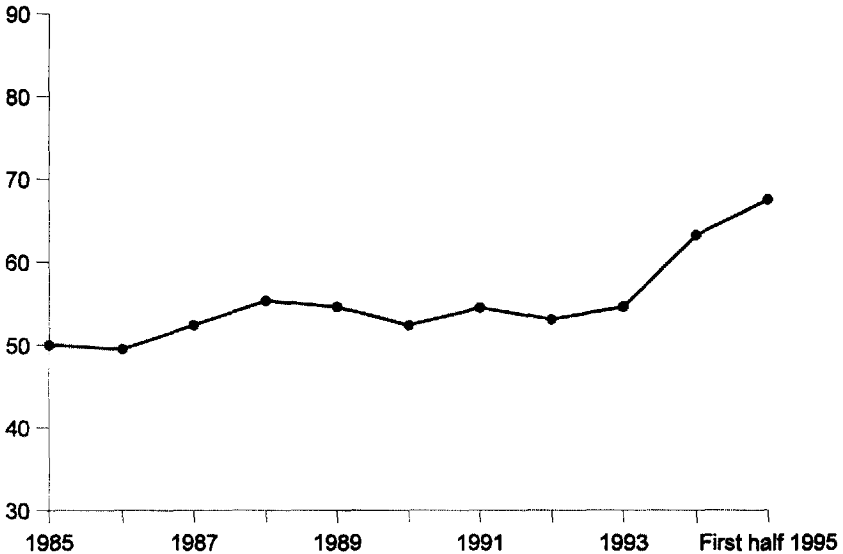


Chart 3 shows our physician-versus-nonphysician experience for the last five years. The physician segment makes up approximately 30% of our business, so anything that impacts physicians as a group will drive our overall results. We all know the long list of items now driving economics in the medical community, such as potential changes in government programs, managed care measures, less physician autonomy, shorter hospital stays, and the search for simplified procedures. In addition, in recent focus group meetings with physicians, we're hearing much less satisfaction in their employment. This, in turn, impacts their motivation and ultimately impacts our claims experience. Certain specialties within the physician groups are showing loss ratios of well over 100%. Knowing that certain specialties have been impacted more by managed care in the recent past than general practitioners, we can draw from this experience a fairly direct connection between economic well-being and our experience. I think there's an important lesson in there. Other types of specialties could be impacted in the future as the medical community continues to adapt to changes.

The primary lesson here is that the world does not remain static after initial underwriting. We're likely to be impacted in the future by other fluctuations in economic and employment conditions, and we're going to need tools that will allow us to keep protection in line with insurable interest. There's a second lesson here also, and that is that 30% of anything in this business is not good from the point of view of spreading risk. We need to broaden our markets and reduce our concentration of business, without any occupation driving as much as 30% of our business.

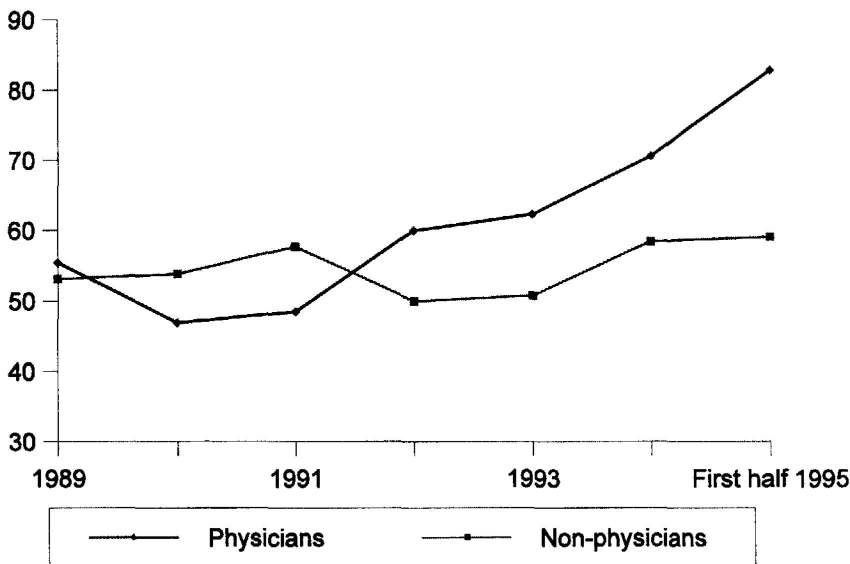


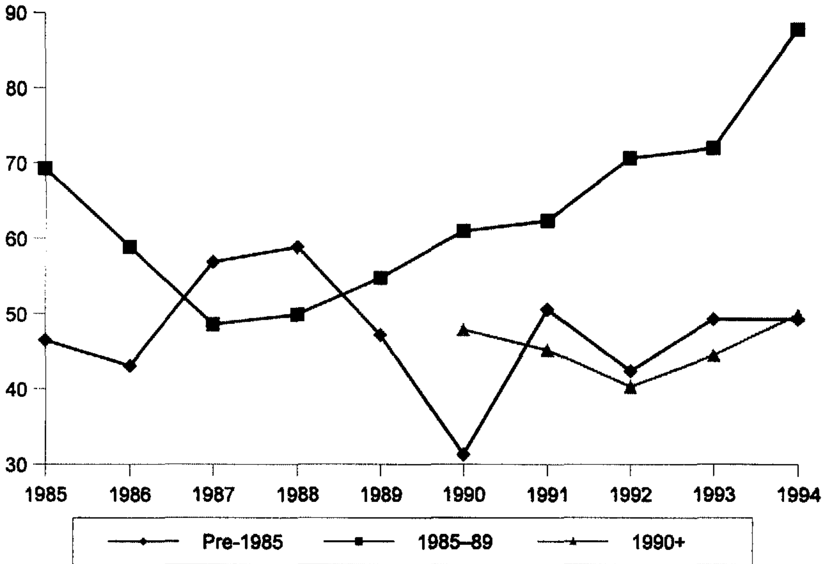
Chart 4 shows experience for business issued during 1985–89 versus that of other issue-year groupings. There's a significant upward tilt in results as this business has moved into later policy durations. This business has always displayed results that are above expectations, but problems have gotten worse over time. The business was sold during a very competitive period in which sales momentum was a very strong driver for major disability insurance writers. The major writers were all competing for the same business.

As a result, this business includes the most aggressive underwriting decisions and policies that were likely being sold rather than purchased. We also had product leapfrogging, which in turn caused much churning within the business. As an indicator, the five-year policy persistency for this business was in the low 40s. That has a significant impact on the results. Normal expectations of five-year policy persistencies should be in the high 60s. So, we've lost, over time, approximately 20% of what I would consider healthy risks in this business. The additional policy lapsations likely impaired the mix of business.

As a comparison, our 1990 and later issue-year business has had early policy duration performance that is better than the 1985–89 issues, which is more in line with expectations. This business has the benefit of tighter underwriting, a higher rate basis in certain segments and some benefit restrictions. The positive indicator here is that the five-year policy persistency during the last four years on all of our business has moved back up into the high 60s. An important question emerges out of this comparison. What is it that drives long-duration performance in this business? Is it initial underwriting, strong policy persistency, a solid rate basis, or is there some impact of unforeseen events? It's likely that all these play a role. If there's any message from the 1985-to-1989 business that we

should extract, it's that an approach that broadens markets, reduces heated competition, and also provides some protection against unforeseen events is probably needed within this business.

CHART 4
PAUL REVERE LIFE INSURANCE COMPANY
INTEREST-ADJUSTED LOSS RATIOS
ISSUE-YEAR GROUPINGS



I'd like to turn from these observations to a few thoughts on our future direction. How can we can expand markets, lower risk, and continue to meet policyholder needs? Most companies are attacking this problem by considering changes to product offerings. One debate going on right now is whether the solution lies in guaranteed-renewable-versus-noncancellable coverage. We may not be thinking creatively enough concerning contract guarantees if we consider this to be a black-and-white question in nature. What product guarantees are important to policyholders? I'd suggest that a predictable cost, the availability of benefits to age 65 regardless of medical condition, and portability are probably the most important guarantees we offer.

What type of product might a company be interested in offering? A product that includes some limited protection against unforeseen events and an ability to keep benefits in line with earnings levels. Do these objectives conflict? I don't think so. I'd also ask us to think about what's in a name. Is there only one type of noncancelable coverage? Are there slight variations in noncancelable coverage that can provide some protection to companies, while at the same time still offer a substantial guarantee in the product? I think these issues need to be probed within our industry.

Let's take a look at a product idea that could meet policyholder and company needs.

Low-risk noncancelable product

- Provides a base of long-term coverage
  - Up to 50% replacement of after-tax income
  - Level premium funding
  - Current rates; maximum 20% adjustment
  - Coverage guaranteed as to medical condition
- Additional coverage
  - Up to 30% of after-tax income
  - Adjusted with changes in earnings
  - Yearly renewable term (YRT) rate structure
  - Current rates; maximum 20% adjustment
  - Coverage guaranteed as to medical condition
- Limited residual and own-occupation benefits
- Coordination of benefits with other sources

The product outlined could be offered to small groups of 3 to 30 lives, with incomes less than $100,000. It would be most applicable when employers do not want to bear the cost of a disability program, but would prefer to have some type of a disability product available to employees. Offering a disability product in this sort of an environment would make tracking of earnings fairly easy. I think that will be important going forward. Agent compensation could be more levelized, given a fairly efficient means of product distribution. All these factors can create value to the end consumer. The product would significantly reduce risk of overinsurance and allow for coordination of benefits with other sources. Own-occupation and residual benefits could be limited and could be considered a transitional benefit rather than lifestyle coverage.

Of all the elements listed, I think the most controversial element is the coordination of benefits. I also believe it's very important that we have some protection against overinsurance in that area. If a product of this type is offered and kept fairly simple, there's an opportunity here to offer valuable benefits at a low cost to consumers. This product could be offered in other settings, and it would have a slightly less attractive cost. Can it compete effectively with group insurance? Yes, I think it can—it still has portability, attractive benefits, some element of level premium funding, and meaningful rate guarantees, the important items we compete upon.

One of the issues associated with this type of product is that ongoing financial underwriting will take additional effort. Will these efforts pay off? How will financial information be assembled, and for complex cases, how will it be interpreted? What are the legal ramifications of tracking income levels? If we can overcome these obstacles, we will push competition into more logical areas such as quality of underwriting, rather than base it purely on product specifications. We're beginning to see technology, such as imaging, impacting the underwriting process. Advancements such as this are probably the areas where we want healthy competition going on within the industry. Can the product be called a noncancelable product? In my view, yes. The rate guarantee is strong. It should allow for this. The coverage is guaranteed to be in place through age 65 and has a maximum set of rates with a stable set of benefits in relationship to earnings.

I'd like to leave you with the thought that the disability insurance business is going through a round of searching for additional measures, measures that are tied to proper fundamentals and which drive profitability. It's an exciting time to be involved in the line of business, as I believe the changes being contemplated will have a long-term and lasting impact on the industry. I believe the changes will lead to better results for companies and policyholders going forward.

MR. ROBERT G. TAYLOR: Given the time frames that we have and what we want to cover, I'll try to just touch on what I think are some real key issues that have been going on in the group long-term disability business. I hope we can walk away with a better feel for how the business is doing and maybe where it's going to go in the next few years. In 1994, all the things that could have gone wrong, in long-term disability, in my opinion, did go wrong. Many things started to come together, and virtually all those factors came to a head. As a result, we had an awful year, in many respects. In my personal opinion, it was the worst year ever for long-term disability. From a global perspective, all kinds of things happened, such as health care reform coming to a head, which had a dramatic effect on our industry. There was a great deal of insurance company restructuring, refocusing, and merging. Individual disability insurance had severe problems, many of which are very similar to the problems that we experienced in the long-term disability business. All the cultural and economic things that have been building, which directly or indirectly impact long-term disability, came to a head in 1994 and spelled a real problem for the industry.

I thought I'd touch on five things that also contributed to a bad year for 1994. First is the slow market growth coupled with record sales. That's a prescription for trouble. Our best estimate is that the amount of premium in force grew about 6–7%, and yet sales grew about 20%. We also saw continued growth in new disabilities, particularly the soft-tissue disabilities, and in certain occupations. This caused a real problem because many of these illnesses and disabilities are much more complex than those we had to deal with in the past. Increasing incidence plagued the industry overall.

Our public is much more knowledgeable about disability, and they understand the contracts that we've issued and how to get through them, and they have representation that'll help them weave their way through our disability contracts, and that's caused problems on the incidence side. Also the traditional markets that most long-term disability companies of the 1980s migrated to—the doctors, the lawyers, the highly paid professionals—took a turn for the worse. It started to turn about four or five years ago, but it hit us very hard in 1993 and 1994. I've seen this happen particularly in the doctor area. Al alluded to the same problems in individual disability insurance or in noncancelable insurance that can hit the long-term disability business. We also saw this with attorneys, especially the high-paid ones.

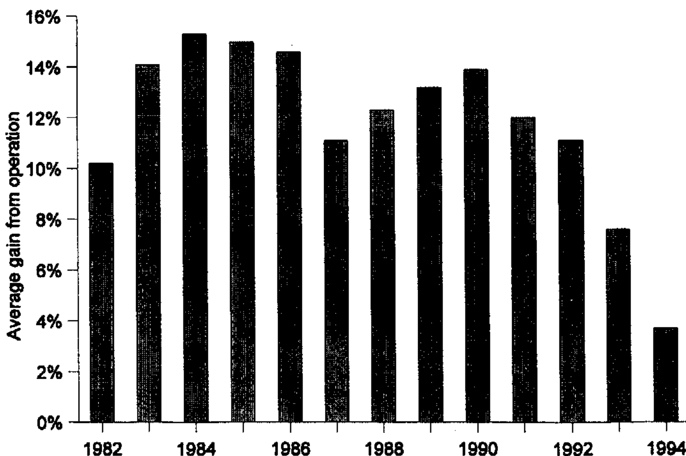
A fourth area was the adverse economic environment. Not only is there a continued period of low interest, which obviously has a direct impact on long-term disability profitability, but there was low inflation. And low inflation, as I'm sure most of you are aware, has an impact on recoveries. There's less pressure to recover in a low-inflation environment. A couple other things about the economic environment that lead to poor results is the whole area of mergers, acquisitions, reengineering, and layoffs. Of course, when higher-paid people have an opportunity to electively choose disability, particularly if they're in their 40s and 50s, they will do so, and that did happen, in our opinion, in 1994.

I think the fifth thing is that in our industry, we've been plagued with what I would call the product life cycle woes. Our industry has essentially been product- and sales-driven for many years. We ran the product feature race back in the 1980s. Many companies, right now, are struggling to determine how to continue to differentiate the existing product within their existing markets, and that's a problem. Of course, in a product life cycle, you'll see where the demand in the marketplace is not growing as rapidly as the supply or the appetite for market share. All in all, 1994 was a bad year, and profits hit bottom for the industry in general.

Let's take a look more specifically at some of these issues. First is profitability. There are not many sources of data for what's happening in the long-term disability business. There are various places you can go to, and there are various debates over what numbers are right and so forth. We happen to feel comfortable with our profit study that we do each year. This is based on 25 of the top 40 insurance companies writing long-term disability. It represents about $3 billion of premium in force and close to a half billion of annual sales. That's, by far, the majority of companies in the business.

What we saw, and I think the most important thing about Chart 5 is not the debate over the level of profit, which we think was about 3.8–4% gain from operations after tax but the shape of the graph; the line just plummets since 1990. This is the result of having to bear the rewards or the spoils from our own sins in the industry. It's a combination of the quest and the thirst for market share in the industry, which has been ferocious. It's caused by inadequate pricing, and we'll see a graph later where we can follow the cycles of the product. Investment returns have been lower than expected, and we may have been overambitious on the interest assumptions. Also, there's also a factor of escalating expenses, which all insurance companies are struggling with at this point.

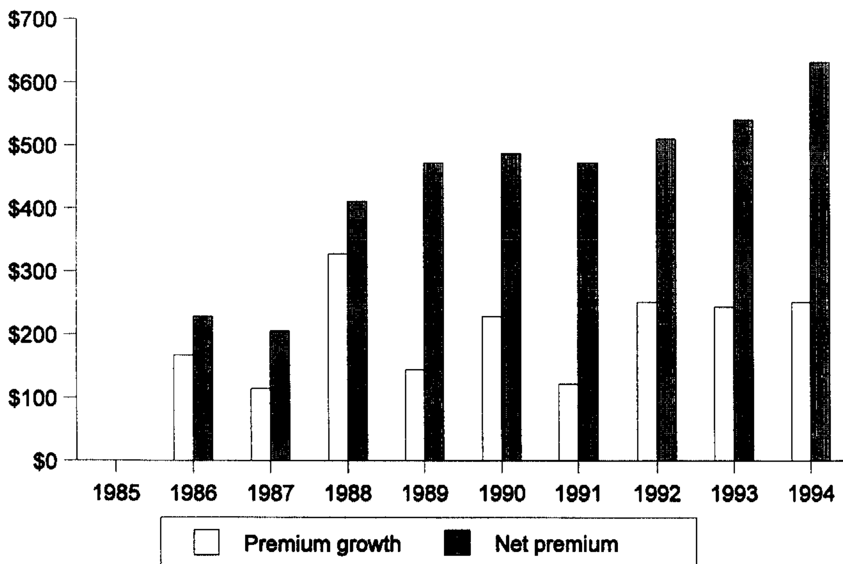
CHART 5
LTD PROFITABILITY TRENDS
LTD PROFIT ESTIMATES AS A PERCENTAGE OF EARNED PREMIUMS
FOR 25 OF THE LARGEST 40 COMPANIES



There are some issues around product liberalization and product proliferation features, and we weren't anticipating things such as changes in the tax code, which allowed for much greater replacement ratios after tax and which have caused a real problem in incidence and some problems in recoveries. Of course, we talked about increasing claims before. So overall, the profitability was dismal and, in our opinion, the majority of companies lost money in 1994.

Chart 6 shows the premium growth in dollars, and we estimate the premium growth of the whole marketplace to be around 6% or 7% in 1994. The other line represents the growth in annualized new sales, which we estimate to be about 18–20% from 1993 to 1994. Most important, though, are the pure dollars involved. The earned premium grew a couple hundred million dollars, in our estimation. That obviously includes rate actions, and it includes wage inflation. New sales are almost three times the growth in premium. Where did that come from? Well, it came from churning; it came from lapses that went way up. It came from fighting a price war. And, as we all know in long-term disability, which is a very low-utilized product, it is very difficult to wedge away a case unless you have clear or superior product or service differentiation, or you have a lower price. This is because most companies that have purchased long-term disability don't utilize the product very often, very unlike medical, dental, and short-term disability.

CHART 6
U.S. INSURED LTD
EARNED PREMIUM GROWTH AND NEW SALES TRENDS

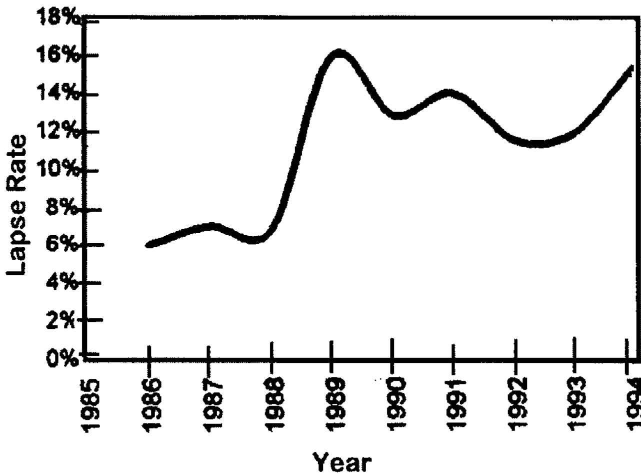


What we're seeing are these product life cycle woes. New companies are getting into the marketplace in response to the so-called untapped potential for providing disability insurance. Many companies are looking to diversify their lines, particularly as they're moving out of medical. This is a prescription for trouble. This gap between growth in the

marketplace and in the appetite for new sales has been starting to manifest itself during the last four or five years.

Let's take a quick look at lapse ratios. As expected, lapse ratios would be up, and it's amazing that when you start overlaying these charts, it's all very basic. Last year, we think lapses hit an all-time high, as seen in Chart 7. High lapse ratios obviously are problematic for our industry in which the direct and indirect cost of acquisition is so high. If this doesn't get under control, we're going to have some serious concerns going down the road as an industry.

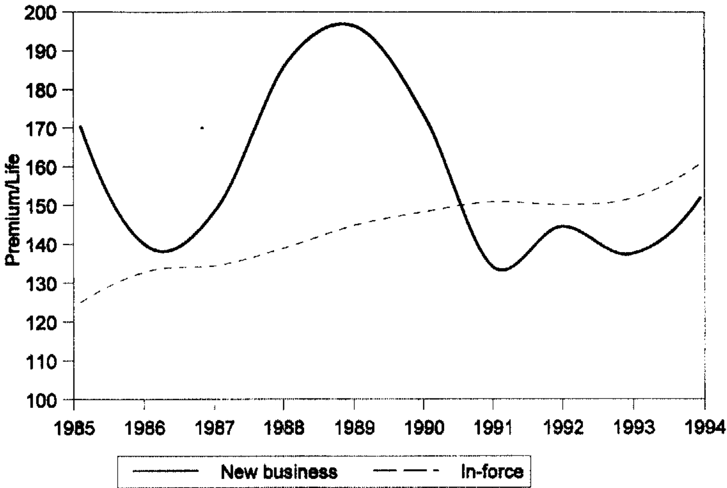
CHART 7
U.S. INSURED LTD
ESTIMATED LAPSE RATIO



We have two lines on Chart 8. The dotted line is the average cost per employee covered for insured long-term disability in the U.S. The solid line is the average cost per employee of new sales reported. If we divide this into stages, up through about 1986, you'll see that the line was moving up, which is fine. At that time, new competition was coming in, there was some consolidation, but there was some new interest in long-term disability, and it was driving new sales costs down. On the next tier, if you go from about 1986 to about 1990, you see the line go way up during the period when the industry went absolutely full bore with new product innovations. Actually, these turned out to be very high-risk features. An example is the superhigh plan maximums that were issued.

Fifteen years ago, when I was selling long-term disability, you couldn't get a maximum over $4,000 or $5,000. Back in the late 1980s, the maximums went as high as $35,000, and some companies issued unlimited maximums for long-term disability. So supermaximums just went through the roof. Simultaneously with that, companies loosened up on mental and nervous benefits. It became standard to get five-day mental and nervous benefits coverage. The industry also loosened up on preexisting conditions and on the definition of disabilities and went full bore into specialty own-occupation.

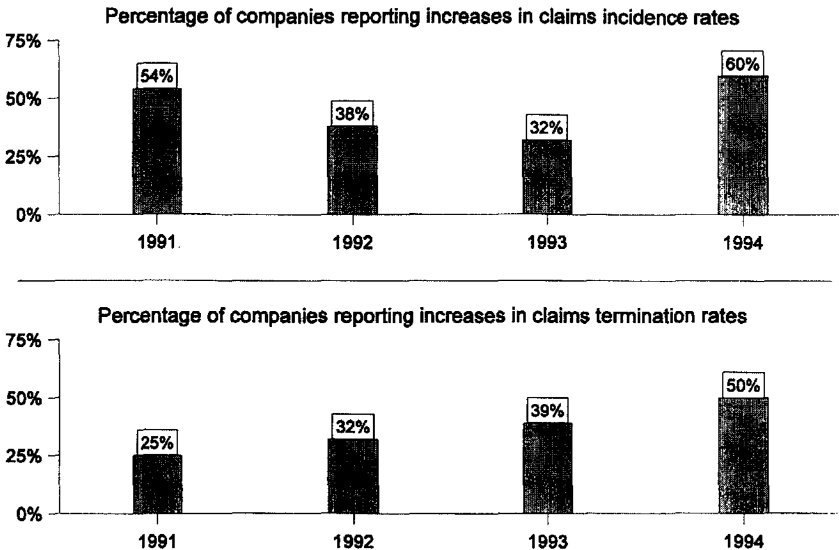
CHART 8
U.S. INSURED LTD
AVERAGE PREMIUM PER LIFE



As you can see, companies were getting premium pricing for that. But what happens in any active and dynamic marketplace? The followers came in and duplicated benefits. They started to compete on price, driving the price down. By the beginning of this decade, in 1990, the new business price line went below the in-force one; it's the classic example of the quest for market share and buying it through price. If you think about long-term disability, there's been virtually no, or very little, product innovation during the last four or five years. Most of the innovation came in the mid-to-late 1980s in terms of features. Now the good news from this is that we think there's evidence that companies are starting to get more aggressive on renewals, more aggressive on new case pricing, and that the gap should be closing.

Chart 9 might stimulate a little discussion at some point. This information was gleaned from the annual rate study that we do for long-term disability. On top are the companies reporting an increase in claims incidence rates. The lower half are the companies reporting an increase in claims termination rates. I think that some of the conventional wisdom might suggest that termination rates are going south, and claims incidence rates are going north. Our information, based on our survey of about 19 companies representing over half the marketplace, says that's not happening. But here's what is happening, in our opinion. From 1993 to 1994, there was a tremendous upswing in incidence. I think that coincides with what's happening in the economic environment and with other factors. There was also a continued improvement in claim termination. But the gap between the increase in the incidence and the increase in the claims termination widened.

CHART 9
LTD CLAIMS INCIDENCE AND TERMINATION TRENDS



The second conclusion that we've drawn, from information that we have, is that the claims that are terminating are not necessarily the high-cost claims, and the claims that are continuing to rise are the high-cost claims, for example, in the medical profession, the legal profession, and so forth. Now, another interesting thing to be learned from this chart, which I think is an important indication, is that companies, during the last three or four years, have been investing very heavily in claims management. And I think this chart gives us some evidence that this is paying off in terms of terminations. They're increasing their aggressiveness in managing those claims and terminating claims, particularly the ones that were marginal and may not have been worthy claims. There is a silver lining to this chart.

That's a scenario of what's been happening in 1994, which was a troubled year for the industry. So let's take a quick look at what some of the industry leaders and other companies in the industry are doing. They're taking many actions, on many different fronts, but I'd like to focus in on four of them. I think the key thing is that the industry is finally responding, and responding aggressively. It's amazing how quickly companies tend to reach when they start to lose money. I'd like to think that we were more forward-looking as an industry, but that may not be the case. The first thing is what we call aggressive right pricing as opposed to across-the-board renewals. Right pricing tells us that companies are starting to segment much more than they have in the past. They're focusing in on key segments, they're not afraid to go after hefty rate increases in certain key areas, and they're getting more astute at backing off, and in some cases, even adjusting rates downward on key profitable segments. We're seeing that more and more in the industry.

I think we're also seeing what I call the institutionalization of the renewal process. For years, in the medical business, we automatically assumed that every year there would be a

medical renewal. That wasn't the case in long-term disability. Long-term disability does not have, or has not had, an institutional renewal process in which the marketplace and an intermediary channel have expected it. That's starting to happen. I think you're going to see that become well entrenched during the next several years. A third thing is that during the mid-to-late 1980s, companies, in their quest for market share and new sales growth, instituted field pricing. I think we've seen the dramatic change in field pricing authority (not field underwriting, but field pricing authority). Many companies that instituted field pricing, pricing pools and so forth, are pulling back and tightening up on those pricing activities within the field. So I think those are probably very positive signs.

Second, I've talked about bringing sanity back into plan design. I would suggest that most of you, if you talk to your field forces, if they're selling long-term disability, constantly get requests such as these: Can you get me a $25,000 maximum benefit? Can you write a group of anesthesiologists? Can you write a huge law firm in Boston with no mental and nervous restrictions, no restrictions on preexisting conditions, a $30,000 maximum benefit, and a specialty own-occupation definition? The answer is no. There's sanity coming back into the underwriting process and into the plan designs. Companies drift away from the high benefit replacement ratios of 70–75%. We see them drift away from the high maximums and the specialty own-occupation definitions. There's also tightening up in the mental and nervous and contributory markets.

Third, target markets have been changing. This is positive for someone who's a marketing guy by trade, that the old way of moving into the disability market and going after the entrenched, perceived best-valued markets has caused disaster in the last couple years. Companies are now starting to learn to be more astute at target marketing, and they're looking at more and more different niches and trying to carve those out, and I think that's a positive thing.

Fourth, as I've mentioned before, is investing in claims management. I think this is a very positive thing that companies are doing, and they're understanding that this has big, big payoffs, whether it's rehabilitation or settlement activities, specialists on staff, or what have you. So I think these are very positive actions. Personally, I don't think they're enough. I think the companies have to get more astute at things on the front end, such as selection. The best claims management is not to have claims, and the best way not to have claims is to make sure that you write the most desirable risks at the right prices.

Let's take a look at a couple things that reinforce this. Part of our study that I thought was interesting was when we asked last winter or last fall what companies were raising rates and in what segments. From the responses, more than three-quarters of the companies were taking rate actions immediately, without any questions, in the physician and legal groups. I think that reinforces the notion that companies are finally responding very quickly to these troubled areas.

We also went and asked the companies, what are you doing for specific, dedicated resources, either internally or using outsourcing for these particular types of specialists? I'd suggest to you that if you looked at the structure of activities of your claims operation in disability ten years ago that you wouldn't see the vast majority of these types of specialists in-house. This is a very positive sign. A high percentage of companies in our survey are using these resources; for example, they are using in-house physicians, rehabilitation counselors, certain types of consultants, CPAs, attorneys, and claims

investigators, either internally or externally, to a much greater extent. This means we're getting much more sophisticated, in my opinion, in managing the disability claims. So I think this is a very positive development.

If we try to capsulize 1994 and what's happening in the long-term disability business, this comes to my mind: I think our industry is moving fairly dramatically, fairly quickly, from a real product-driven mentality to what I call a market-driven mentality. When we started to write a great deal of the long-term disability as an industry in the late 1970s and through the glory years when business was flowing and margins were extremely high in the early 1980s, we had one product, and we took a one-market view toward the marketplace. We determined what the product was, internally, and we shoved it out to the marketplace. We went out and hunted down people who were interested in buying and convinced them that they should buy our product the way we designed it. We weren't challenged the way virtually every other industry—whether it's manufactured goods, consumer goods, or financial goods and services—in this nation is to start moving more toward a true market-driven industry. But I think that's happening now, and I think this is a very positive sign.

I think it will be a difficult struggle for our industry to learn how to move from being sales-driven to marketing-driven, to learn how to develop niches and identify them and be disciplined enough to penetrate those niches with the right types of products, services, distribution, and alignment of all those pieces. This certainly has significant implications for how we move forward in terms of our marketing strategies, our distribution strategies, our corporate and financial strategies, and how we structure our companies and so forth as we look down the road.

As companies start to move toward becoming more niche-driven, there will be an expansion in the markets to be segmented. Companies can segment by distribution system, and the distribution could be direct, it could be a franchise, it could be some form of managing general underwriter, it could be intermediary-driven, or it could be subsets within those distribution channels. It could be segmented by size—actually, we're seeing a great deal of segmentation by size now. It could also be segmented by buyer. The traditional buyer was the employer through the intermediary. Now the employee is the buyer. You could wind up selling some form of long-term disability to a member of an affinity group. You're going to see different types of segmentation in those areas.

The same thing is true with geography—we're seeing more geographical segmentation than ever before. I think there will be an interesting battleground in the services area, particularly as we start to venture into these partnerships with things such as 24-hour coverage, as we expand the view of what disability insurance is all about. But the most important thing here is that, as we start to break apart and move away from the one-market approach into various markets and we develop specific strategies for each of those market niches, I believe it will give us opportunities to do some very important things. One is to clearly establish a differentiation within those markets and to establish barriers to entry. Let's face it, under the old way of doing business, there were virtually no barriers to entry in the long-term disability business. I think that'll help the industry create barriers, which is important. I think it'll also allow for premium pricing. If those things happen, that should lead to profit, and that's what we're all looking for.

Here are a couple thoughts on long-term disability buyers. What's driving the change in the market, in my opinion, is the consumer, the buyer. Here are four thoughts, by no

means are they all-inclusive, that I think about when I look at the marketplace to try to figure out what's going on out there. First is decision making; not only who is making the decisions to purchase our disability products, but also how those decisions are being made. The employee is now in the equation. The benefits department and risk management people are involved. Outside consultants are much more involved now as opposed to just the broker. So the whole decision-making process is changing.

Second is that there's no question that the customers of disability are demanding more than they've ever demanded before. They want flexibility, they want to do it on their terms, they want customization, and they'll tell you that if you can't give that to them, somebody next door will. So competition is heated in this business, and customers, like all of us, are taking advantage of that. Incidentally, I think that when customers are demanding more, they'll go either to the channel or to the company or to the service organization that'll give them specifically what they want.

Third is cost-consciousness. Our buyers are confronted with the same challenges that we are, and everybody's looking to be more efficient and effective at what they do and at how they run their business. They're demanding that of their long-term disability coverage, because they're demanding it of their disability programs in total. There's a much greater awareness of the cost of disability within an organization. Long-term disability now becomes part and parcel to that whole concept. They're saying that we must be cost-efficient and cost-effective. Most consumers will seek value. If they can't find value, they'll seek the lowest price. I think that's happening, and it's causing a little bit of consternation for us as an industry.

Fourth is risk management. Given the awareness on the part of consumers about the ultimate cost of disability and the impact that it has on running their businesses, particularly as we move to a service-type economy and service-type economic environment, where human capital becomes much more important than a machine, companies are becoming more aware and more demanding of what we're doing in the risk management area. We're seeing that very much in the large-case market today, and I think that's starting to filter down into the medium-sized companies. So from an employer perspective, this is an area that we as an industry have to pay much attention to. The bottom line is that consumers are paying more attention to disability, to the cost of disability, and to how long-term disability flows through and impacts that than I think they were five or ten years ago. They're demanding; they're coming to us and saying, "This is what we want. If you can provide it, that's great. If you can't, we're going to go someplace else."

On the distribution issue, personally, I think that it's an incredibly critical piece of the disability business. I also tend to believe that most carriers don't pay much attention to distribution, particularly from a strategic point of view. I think they look at distribution merely as, there's our sales force, and doesn't it cost money to keep them on board. I think companies need to understand that the distribution system, and the distribution channels within that system that they're going to employ, can be a very critical piece of carving out a value-added service. The evidence is starting to show very clearly that the companies that view it from that perspective are the companies that are gaining market share and, in general, are reaping more of the profits in this business.

I'll give you an example. Of the top ten long-term disability writers last year, the vast majority, I think about nine, have specialty distribution forces within their own

organizations. What I mean by specialty is where a person is spending the majority of his or her time understanding and focusing on disability sales. So we're seeing that tension come within the internal distribution system or systems and the external ones through the brokerage or the intermediary channel.

New competition is confronting us as an industry, not only from suppliers, whether they be third-party administrators or HMOs or property and casualty companies or companies that used to be in the medical business that are looking for alternate types of products and markets, but also from the brokerage channels. There is a great deal of consolidation in the brokerage channels, and more brokers who weren't in the disability field, or intermediaries or consultants, are becoming much more aware of that. Even property and casualty brokers are getting squeezed on the property and casualty side to search out new forms of revenue compensation.

Specialization is on the rise within the insurance industry and also within the brokerage channel. Twenty years ago, when I was out selling, it was rare to find an intermediary who specialized in disability insurance. Today, every city and every town has a group of people who are specializing in those areas. Specialization means that they're going to have higher expectations of us, as an insurance industry, to support their needs and enhance their knowledge and fill in the gaps so they can write business and keep it on the books.

Another area is new compensation. This is a hot button for me. I think the compensation system is poised to dramatically change during the next five years in our industry. The days of paying every intermediary 15%, regardless of what they do on long-term disability, I think, is destined to change dramatically. We're seeing a tremendous rise in fee, and using a fee structure is good, because it tells us that the employer or the purchaser will pay us what they think we're worth. I think you're going to see more of that and it can have some dramatic impacts, I think, on how we'll distribute these products in the future. We're seeing much more change in distribution systems within insurance companies as they move toward a more specialty type of focus.

Another area is the whole concept of building value-added service. The days of banging on brokers' doors, seeing how they are doing, getting to know them, and then have them support us and ride with us and our companies, I think, are fast going by the wayside. Every consumer is demanding value, and every stop along the distribution channel will have to develop some methodologies of delivering added value as we move along that chain. I think the long-term disability industry needs to find creative ways to help its distribution partners improve that value added, not only in their internal sales organizations, but also in their external ones. I think the bottom line is that consumers are demanding more of the distribution system. They're going to say, "If you're not providing value, we don't need you." And I think that as we move forward, companies will have to manage multiple distribution systems, which is uncomfortable for our industry. Companies will have to start looking at distribution as an investment rather than as an expense. We're going to have to get more comfortable in developing alliances, sharing some of the functions and maybe some of the risk decisions with our distribution channels and become more efficient and more effective. So some things are happening there.

Looking ahead, a couple things stand out in my mind. First, as an industry, we have to start looking at the long-term disability business not as a product, but from a much

broader perspective. If we do that, that'll help us understand how to deal in the 24-hour coverage area, which to me has been much more talk than action right now on a global perspective. It'll help in the areas of voluntary coverage, which addresses the needs of a new purchaser. Also, it'll provide assistance in the integration of the short term and the long term, which seems to be moving rapidly. It has implications in the whole area of managed disability. The industry has to look more globally at that, because those developments are already occurring.

Second, the need to continue to enhance risk management expertise is critical. Ultimately, we're in the risk transfer business, and that's why people come to us. To understand the changing dynamics of a marketplace and the employment place and new regulation, whether it's the Americans with Disabilities Act or whatever, we must continue to invest heavily in honing our skills on risk management.

Third is that we must develop market-driven cultures, which focus on working from the outside in. It's interesting because the automobile industry ten years ago, particularly the U.S. car manufacturers, didn't produce customer-driven types of automobiles. But with all the different features that they offer today, they're reaching out and finding out what the customers want, and they are developing brands and developing flexibility to give it to the customer on a customized basis. That's what we have to start thinking about as an industry. We must move away from the functional approach to product development and product distribution and think more about smaller niches and customization. That will require much more investment in knowledge of what's happening in the marketplace, down to the consumer level, in the group long-term disability area.

Fourth, we need to view distribution strategically. I've already discussed that, but the things I like to think about when I mention that are developing a value-based approach to developing the distribution strategy—focusing on alignment, that distribution is not a necessary evil, but a critical, strategic part of disability offerings. If you view it that way, I think you'll probably be pleased with the results.

Finally there is the whole issue of how we, as an industry, continue to create new and different ways of manifesting the notion of value in the eyes of our channels and our customers. That's going to be a challenge. Overall, I think the industry has, despite what happened in 1994, turned the corner and we're looking toward much better results down the road. But it won't be the same-old same-old. It's not the way we used to do it. It will have to change. I'm very encouraged, because I think many companies are starting to make the types of changes that need to be made in long-term disability.

MR. DAVID J. CHRISTIANSON: Al and Bob, you both mentioned more claims investigation and claims management, which I think is very good, but what is the downside of that? Are there any cautions, especially in terms of lawsuits and that type of thing?

MR. RIGGIERI: There are some obvious things you might not want to do. Focusing on a specific occupational group is probably not a good thing to do in your claims management operation. It seems to cut against fair treatment. Focusing on different types of disabilities is positive. There are totally different ways of handling a mental nervous claim versus a heart condition, versus a simple broken leg or a muscular impairment. Those things seem to just make sense from a claims point of view. So you go down to the basics of

what makes sense in a claim operation. I also think that there are other aspects of claims management that are important in our business.

One is that we need face-to-face contact with claimants. The days of sitting in the home office and calling on the phone for a few forms are gone, particularly in high-risk claims. I think that can help us. I think early intervention is important. There's a hurdle in individual disability with long-term elimination periods in that it doesn't allow you to get in as early. So I think we may need to get over some of that hurdle. Finally, disability management seems to make some sense in which a group of people are involved in managing the claim and not just a single claim examiner, with all the support services. Those things come to mind when I think about claims management.

MR. TAYLOR: I think that if you get aggressive immediately and do some things that might be considered to be borderline reckless, you're inviting problems. So I think you need to focus on early intervention right away and find ways to get in touch with that claimant as soon as possible. Have a communication plan or a communication strategy that's consistent throughout. Make sure that you have consistency through your whole organization so that anybody who touches that claimant early on gives a consistent message. The other thing is good documentation and follow-up. It's amazing that many companies struggle with those two things, particularly good documentation. You can get torn apart on the documentation issue. The same thing is true with follow-up. So the early intervention, early communication, consistency, good follow-up, and good documentation will help you avoid some of the potential legal issues.

MR. STEPHEN M. MAHER: I have a comment for Bob regarding the draft you put up with regard to the average amount per employee for the cost of long-term disability coverage. Although I agree that the competitive nature of the market certainly is a factor, other factors to consider are the fact that the whole product that is being offered to the new market now is a much leaner product. Voluntary products and core buy-up products also lower the cost, and there is the dramatic move away from the physician and attorney markets. Lower maximums also are major contributors to that. But I'd also agree that the competitive nature is certainly a major component of that.

MR. TAYLOR: I think you're right on the money. It's very hard to adjust those charts to take that into account. One thing to keep in mind, though, is that I think that the tightening started a couple years ago, probably before that line started to go down.

MR. MAHER: Al, with regard to putting in a coordination of benefit for an individual product, how do you decide who's primary when you put coordination of benefits for individual products in a group product?

MR. RIGGIERI: That's difficult. We'd obviously both like to be secondary. Maybe there should be a fair splitting of benefits. The key there, though, is to put the onus on the policyholders to keep us informed of their coverage, because that helps us keep out of the situation where we have to coordinate benefits, and we have the overinsurance risk. That helps on the back end, but you'd like to catch it more up at the front end and solve the problem where the source is.

FROM THE FLOOR: One thing I'd like to stress on disability pricing and early intervention is the need for management's cooperation to assist the actuary in setting up the prices

properly. We've been through a similar situation, as you both have indicated, and the general practice that followed was to put up the prices incrementally. The incremental approach was not the right approach, because losses continued. In such a situation I would say, have the courage to put up the prices, if you have to put up the prices 8% or 7%, for the particular occasion.

MR. TAYLOR: I think that's a good point. Being from the marketing side, I can tell you I had a few interesting meetings in my lifetime with the actuarial staff. I think, in line with your comment, it's important to continue focusing in. For example, the industry should have been more aggressive four or five years ago in the physician market and paid less attention to the potential marketplace ramifications of severe pricing actions.