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IS NONCANCELLABLE DISABILITY INCOME VIABLE?

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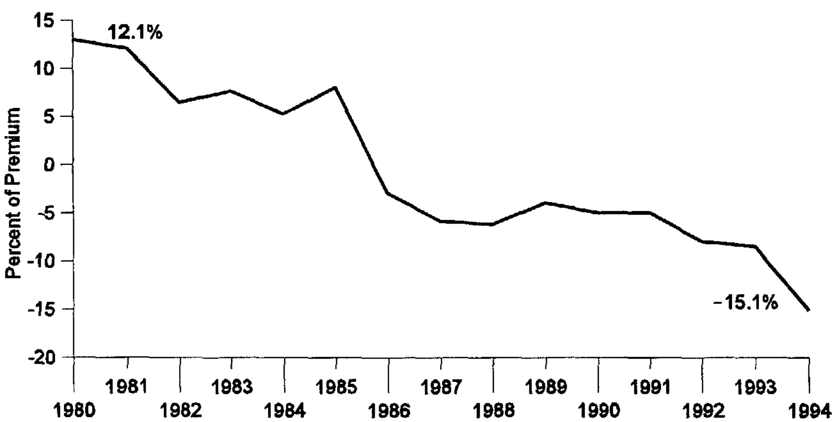
Many companies are questioning the viability of selling disability income (DI) insurance at guaranteed prices. What are the alternatives to noncancellable DI and where is the market going? Three major writers of individual noncancellable DI will discuss their views of the viability of noncancellable DI and some of the steps their companies have taken or are planning to take to address their concerns.

MR. DAVID E. SCARLETT: Chart 1 shows statutory earnings after dividends and after federal income tax for the largest nine companies in the noncancellable DI marketplace.

CHART 1
PROFIT



Those nine companies account for more than 65% of the noncancellable DI premium in the U.S. You can see that 15 years ago this industry was healthy; profit as a percentage of premium was 12.1% in 1980. However, it has been mostly downhill ever since, with 1985 being the last positive year and 1994 being the worst year yet at −15.1%.

Our panel of John Lenser from Guardian, Dave Simbro from Northwestern Mutual, and Dan Skwire from UNUM will answer the question, Is noncancellable disability income viable? To start, let me introduce John Lenser. John is second vice president and actuary at Guardian Life Insurance Company of America, where he's in charge of all actuarial aspects of individual DI and medical care insurance.

MR. JOHN M. LENSER: First let me say that the Guardian is not one of the giants of the individual DI industry. We are, however, still firmly in the individual DI business, and that in itself is significant. The Guardian, by sheer persistence and survival, has inched farther and farther up the size ladder for individual DI operations. We're getting closer and closer to the giants in terms of business in force, premium in force, and sales. We believe that this is still a good business to be in, and that many positive things have been happening despite the profit as a percentage of premium is negative in 1994 as shown in Chart 1.

Now let me get back to the basic question, Is noncancellable DI viable? I'm going to respond to the question by defining what I see as the environment (that is, the situation) in which we find it necessary to ask this question.

If I had a chart, it would graph loss ratios as a function of time, starting at about 1970. You would see a blip back in the mid-1970s, the last time that we had a scare of some size. Then you'd see a fairly level pattern with little movement up or down all the way to about 1986 or so. Then you would see the graph shoot up sharply for all the years through 1994.

For another chart, I would take the first chart and flip it over. It would then be similar to Chart 1 showing statutory earnings after dividends and federal income tax. The graph in this chart starts to drop off steeply around 1985 or 1986. That's the environment in which we're presenting the question of noncancellable DI viability. I want to make four points that relate to that environment. Only one deals with the specific question that we've raised here, because my goal is not simply to address the viability of noncancellable DI. We are dealing with a much broader question that has to do with the losses we've taken recently and the loss ratios that the industry has experienced in recent years. I'll quickly present my four points, and then I will discuss each in more detail.

First, I would say the problem of losses and loss ratios does not lie with the noncancellable renewability feature in individual DI policies. Noncancellable is not the culprit, and we at the Guardian don't believe the solutions that we've seen bandied about over the course of the past six or eight months—which have mostly involved guaranteed renewable products—are the solutions to the situation in which we find ourselves.

My second point has to do with where I think our focus needs to shift to address this problem. We need to focus on certain fundamental aspects of the DI business. The first of those aspects has to do with the changing markets that we serve and the products that we believe those markets need. We've become removed from the basic benefit structures and the basic needs that our markets require. I also want to talk a bit about some of the fundamental functions that we as individual DI insurers carry out in serving our policyholders. I believe the problems we saw in the 1980s arose in large part from our failure to carry out those functions in a satisfactory fashion.

My third point has to do with the cyclical nature of industries such as ours and the coming and going of tides of events. Often a flow in historical events—whether we're talking about business or social patterns or economic developments—carries all the participants along. It can be a negative or positive sort of flow. The tide certainly flowed out adversely with respect to individual DI carriers in the late 1980s. We caused that to some degree ourselves, but many forces over which we had some limited control also had a bearing on what happened. We see parallel occurrences in some other industries. I think of the airline industry, which has been involved in competitive wars; there has been a competitive frenzy in that industry for probably the same period of time that we've had problems in DI, and you see some indications that the airline industry may come out of it. You see some companies returning to profitability, but you've also seen a history of losses and a history of companies going into reorganization. That flow has to be addressed and dealt with.

My fourth point has to do with what I see as a turning of that tide. I think the actions that companies have taken in the last year or so, and some actions from even three or four years ago, have begun to turn that tide very slowly. I believe that there are forces, again in large part outside the individual DI industry, that are also contributing to the turning of the tide. That favorable sort of tide is going to be characterized not by competitive frenzy, as I think the earlier period was, but by a focus on financial soundness that others now force upon us and will continue to force upon us. There is, I believe, a window of opportunity here where we will have the chance to take actions that actuaries would tend to think are financially sound. We haven't seen a situation such as this for probably 15 years or more. So I'm going to spend a little time on each of these four points to tell you how I think the industry is going to go about correcting the situation that has evolved here.

With respect to point one, the question of noncancellable DI viability, we have spent some time thinking about that same question back in the late part of last year; maybe it was around the time that the Provident guaranteed renewable product came out and there was a great deal of talk in the industry about guaranteed renewable. Our management began to hear about it and would say to us things such as, "Why don't we do guaranteed renewable?" The actuaries in the individual DI area talked about that option, and we thought it was not the solution to the problems confronting us. There are several reasons for that.

At the Guardian, an old medical care line of insurance is guaranteed renewable. Some of those policies go back 40 years. We stopped writing that business more than ten years ago, but we are stuck with it. We have to get rate increases frequently. In addition, we have to deal with 50 states that change their regulations frequently; there's no real consistency from state to state. We don't believe that guaranteed renewable is something that we want to administer, especially when there's a huge premium volume involved, as it would be for our DI business.

We think the other problem with the administration of rate increases for guaranteed renewable policies is that the product we sell is a long-term disability benefit with a cost-of-living adjustment and many other liberal provisions. These provisions have a tendency to create volatility in financial results. We're a company of some size, yet there is considerable volatility in our financial results from year to year, caused in large part by claim reserves. We think it's difficult to go to an insurance department and justify a rate increase until there's a clearly established pattern of something more than mere volatility that would justify a rate increase. So we're not enthusiastic about administering rate increases, and we think these rate increases would by no means solve all our problems. In addition to that, our noncancellable products are priced to return about 50% of the premium to the policyholder. On a guaranteed renewable product, that would likely have to go to 55%, because that's the minimum loss ratio requirement in many states. We are squeezed very tightly with respect to profit margins now. We don't have room to take 5% out-of-profit margins and give it to the policyholder. We would probably have to take it out of compensation, and we don't think that is a practical alternative, either.

We also believe that the rate reductions that are being talked about for guaranteed renewable products relative to noncancellable (such as 15% or more) aren't consistent with what can be done with a guaranteed renewable product, not for us anyway. A publication of Paul Revere called *Market Watch* took the same arguments that we had in our minds and put them on paper very well. If you have to talk to management about why you think guaranteed renewable is good or bad, there's a case made in this publication for continuing noncancellable products.

My second point has to do with the fundamental things that we need to do better to address the problems the industry has encountered. We need to design a product that doesn't have the problematic features characteristic of the products sold in the early 1980s. What does the public need? What do our markets actually need? We believe there's a real and substantial market out there that goes beyond the largely professional market that we've written in the past. The answer to the question of need seems to me to be so obvious that we don't have to deal with it to any great extent. Young professionals, such as physicians, attorneys, CPAs, and business people, have made a large investment in their careers. They need to provide for families and for all their needs, for college educations and the like. The need for a DI product that provides basic benefits is so obvious that we don't even need to address it. The need is there and there is a place for our industry.

I'll get into the question of the types of benefits that should be offered a little more when I address my third point, because it has to do with the things that I think we did badly in terms of benefit structures in the 1980s and the things that we're already trying to do well in the 1990s. Beyond the benefit structure that we provide to our clients, we sell a service that I would say consists of several components. We sell underwriting services, policy-holder administration services, claim administration services, and investment services. One of our primary responsibilities, I believe, is to classify risks properly—to group people in the underwriting classes that are fair, that reflect their risk characteristics, and that are consistent with our pricing. When we fail to do this, as I think we failed to do quite often in the past, we do a disservice to our policyholders. We don't provide policyholders with the service they are paying for when we allow lax underwriting, poor financial standards, or poor financial documentation which eventually perpetuates fraud against us. Then we're doing a disservice to all the policyholders who expect a great deal more of us than that. So I think we need to focus on the fundamental services and the fundamental benefit structures that we provide. That's a big issue and much more important, I think, than the noncancellable viability issue.

The third point that I want to talk about is the tide of events that carried us through a period that began in the early 1980s and ran for about ten years before we began to see what had happened to us and take corrective actions. The early 1980s followed a period of high loss ratios and many adjustments in the industry. Then slow liberalizations in benefits occurred (for example, own-occupation provisions were liberalized, residual benefits became much more prominent, and qualification periods for residual benefits were shortened or done away with). In late 1979, we came into a period of very high interest rates, which continued for a number of years. CPI rates were very high, and we ended up with products that reflected that time. We thought there was a need to provide policyholders with cost-of-living-adjustment benefits of some size because we were in a period of high inflation.

What happened, unfortunately, was that the momentum built, there was a leapfrogging by companies, and the benefits became even more liberal. We went well beyond the needs that we had to meet. The combination of liberal benefits, leapfrogging, and the inadequate experience databases created pricing inadequacies that came back to hurt us a great deal. We recognized it in the late 1980s and even more forcefully in 1993–94 when some companies had to publicly recognize those losses.

The point that I made about pricing inadequacies and liberalizations in benefits is illustrated well in a piece of material that Paul Revere has developed. There is a bar graph with a dotted line running horizontally across it representing the expected experience level in its pricing. Then a half dozen or so bar graphs either cross that line or don't cross that line. The first bar graph is for total disability benefits. By whatever measurement it is using and for whatever period of time it is looking at, the total disability benefits were more than adequately priced because the experience did not exceed the pricing expectations. Then bar graph by bar graph is added—the own-occupation benefit, the lifetime benefit, and residual benefit. Then combinations of those benefits are added and the bar graphs just go up so that they're all above the dotted line.

We found that combinations of benefit features that we hadn't seen in the late 1970s were producing experience in the late 1980s that was worse than we had anticipated. It came about for several reasons. I attribute it primarily to the tide of events, the offering of more generous benefits, and some lack of knowledge in pricing. I believe that the series of events that began back in 1990 or so is creating a tide that's pushing us in the opposite (that is, positive) direction. I think this current tide has financial considerations as the prominent feature of its flow. This is in contrast to the previous situation when the industry was moved by a competitive frenzy.

The basic question that I think is associated with this current tide would be phrased something like, "Is the individual disability income business a good place to invest capital?" or "Can a satisfactory return be earned on such an investment?" I think that's the driving force behind the current tide of change in this industry. Stock company investor considerations are a major aspect of this, and they are becoming more important. Whether stock company investors and the managements and the boards of directors at mutual insurance companies allow their money and other resources to be directed to individual DI operations will be driven by financial considerations.

I want to read a piece from an article in the November 14, 1994 *National Underwriter* that supports the point that I'm trying to make. It is a report on UNUM's decision to leave the individual DI market. The article says that the profit objective is an overall return on equity of about 15%. Jim Orr, chairperson and chief executive officer of UNUM, says in this article, "When we stood back and looked at the individual disability business, we knew that what we had to do was take some aggressive steps with respect to that line of business. Even with the best year ever in 1993, we basically had approximately a 10% return on equity on that block of business. So even with record results, we still had inadequate returns on the business. We basically had a huge amount of capital tied up earning little more than a government bond rate and that's just inadequate." I think what Jim Orr had to say reflects the feelings of many other people who are providing the investment funds to the industry at this point.

I'd like to cite a couple other forces that I believe are part of this current movement. One of the issues that's becoming more prominent is risk-based capital; it's a number that is seen by many people, and there's a good deal of focus by company management on risk-based capital. You need good numbers in this area. If you think that DI is dragging your company down by volatility in the business or by not producing adequate returns, then risk-based-capital questions are going to affect your thinking as to whether you will be in this business, what way you'll be in it, and the sort of return that you're going to have to earn.

The last item that I would cite in terms of the financial considerations that are going to drive this industry over some period of time is GAAP for mutuals. In my company, we are just beginning to do GAAP for the individual DI line. Historically, we have looked at individual DI operations by looking at slightly modified statutory numbers. That's a grossly inadequate basis for measuring the performance of an individual DI unit. Twenty years ago, you might have been able to look at loss ratios on your individual health line of business, which included much DI and some medical care, and draw some conclusions from loss ratios and statutory statements. But investment income is such an enormous part of the business that we can't look at it the way we used to, and GAAP for mutuals will be an important device for mutual companies to use in looking at their individual DI business. I think that will make them focus more than ever on financial considerations.

So to summarize, the problem is not noncancellable versus guaranteed renewable. First, it's a problem of getting the industry out of a position that it has worked itself into over a period of many years. As to the question of viability of noncancellable versus DI, we would opt for noncancellable if the only option is guaranteed renewable, although I think in the long run we may see some alternatives. Second, the real issue here is that we need to get back to fundamentals with respect to the benefit we're providing to the policyholder and with respect to the way we run our businesses. Third, I believe that part of what hurt us in the 1980s was a whole tide of events over which we had some control. It was a period of time when, whether you were a prudent company or an imprudent company, you were going to suffer. If you were prudent, you may have gotten through with small losses or small gains; if you were imprudent, you may have lost much of your capital and may no longer be in the business. Finally, I think the tide has turned, and financial considerations are going to drive the industry for some time. That will allow all of us to price our products more prudently and to get our business back on profitable ground.

MR. SCARLETT: I think I heard a "yes" there. That is, DI is viable if you manage it correctly and if your corporate objectives are consistent with what you can reasonably expect to earn from noncancellable DI.

Let me now introduce our next speaker. Dave Simbro has the title of actuary at Northwestern Mutual. He's in charge of product development for individual DI, group LTD, and long-term-care research.

MR. DAVID W. SIMBRO: I'm going to try to address the basic question, Is noncancellable DI viable? The answer will be based on my own company's perspective. We think that it is viable, *but* there are some situations where it's probably not viable because of the way we do things today. The three key issues I want to go through are: (1) noncancellable DI may be viable if there's an appropriate level of margins built into the product; (2) whether noncancellable DI is viable is largely a function of what's being insured; and (3) if noncancellable DI is not particularly needed in the marketplace, then guaranteed renewable may be better.

There are many situations in which, at least at our own company, we've had fairly favorable DI experience. One example is waiver-of-premium experience on life insurance. We're guaranteeing the rate, we're providing disability protection, yet we have not seen the same claims experience on that type of coverage that we have seen on disability income. Another example is with overhead expense coverage—even on doctors whom we insure for overhead expense coverage, we have had fairly decent experience. (With respect to doctors, when they're insured for DI, the experience hasn't been so favorable.) Another example of a situation in which the experience has been fairly favorable for us is our nonmedical market. Basically everyone insured under what I call our traditional DI product, which is our noncancellable product without all the bells and whistles, has had favorable experience. In trying to determine why the experience has been as mentioned, I think we must look at two key elements. The overriding one is that there is a strong link between the benefit and the loss, particularly with waiver-of-premium experience on life insurance and overhead expense experience. For overhead expense coverage, you don't have ways to profit from a claim or have the potential poor link between what's paid out and the loss that's incurred. The other element is that the favorable experience in the nonmedical markets may be nothing more than a result of the current economic forces.

Of course, looking at this the other way, we've all heard of the numerous situations in which we've had poor results. Listed below are some of the examples in which noncancellable has had problems:

- Own-occupation benefit
- Ignoring Social Security
- Taxable extra coverage guaranteed at issue
- Lifetime benefit period
- 100% benefit for proportionate disabilities

I don't think this list is exhaustive, but each item hits on the basic point: when you have a poor link between the benefit and a loss that's incurred, results can be unfavorable. The typical example is the own-occupation benefit. Just because someone can't perform his or her occupation, benefits are automatically paid. We've seen the results this benefit has produced for companies.

Another example is not integrating coverage with Social Security. If you look at the replacement ratios for someone making $50,000 or $100,000 per year, you would see they're extremely high when you take Social Security payments into account on top of the disability benefits. That has a significant impact on the rate of claim. Studies have shown the correlation between rates of claim and replacement ratios. If changes were made here, I think you'd see a dramatic difference in the experience.

Another example of a poor link between the benefit and a loss is when we provide guaranteed taxable extra coverage at issue. Regardless of what happens at claim time, whether or not the benefit is actually taxable at that time, we pay that extra amount. If you take a look at your own experience, I think you'll find significant differences in experience on those who have this taxable extra coverage and end up having a nontaxable claim. A high proportion of our insureds are issued taxable extra amounts. Something dramatically changes in their lifestyle, the benefits are suddenly nontaxable at claim, and their claims last at least 25% longer than other claims.

Another example of the poor link between the benefits and a loss is with the lifetime benefit period. My company's contract has the potential for a large windfall to the insured. If you become disabled at the right point and stay on claim, the amount that is paid bears no relationship to what was lost in terms of retirement income funding, which was the underlying purpose of this benefit in the first place. As expected, the experience on lifetime benefit periods gets quite poor at the older ages.

Another example of a poor link is providing benefit payments for proportionate disabilities that aren't in direct relationship to the loss. We found in our own company that an extremely high percentage of payments were made for proportionate benefits, relative to what you would think would be paid; it wasn't even close to 50% or 60%. Many situations in which there is clearly a problem present the opportunity to collect much more than the real loss, and this opportunity was seized.

At my company, we still think that there are situations in which noncancellable is appropriate, but we've done a number of things to allow us to feel this way. Basically, we've improved the margins, and we've improved the link in our contract between the benefit and the loss. We're still offering noncancellable on what we call the QQ series. It's something we introduced a little more than a year ago. There are three key elements to this contract. One is that we increased the premiums, and within the premium structure we changed things around to improve the equity—we added area rating, moved occupations around, and went back to sex-distinct pricing. Much of that was an attempt to improve the margins and the underlying product. Second, part of the insured's issue and participation limit has to be fulfilled by our social insurance benefits. Third, we've made some changes to the product offered to the medical market. Early in January 1995, we made these changes after we discovered a significant change in our medical market experience in 1994. All the changes pertain to issue and participation limits but again focus on improving the link between the benefit and a loss. Probably the biggest change is that we eliminated providing taxable extra coverage to physicians. Even if they tell us the benefit is taxable, they're still issued under the same issue and participation limit schedule that applies to nontaxable benefits. Another change is that we no longer insure deferred income. These changes have had a significant impact on the amount of coverage we'll provide to physicians, and they provide a much better link between what we're insuring and the underlying need.

That's a general overview of what we've done with noncancellable DI. What I want to do now is turn the question around and ask, Is guaranteed renewable viable? or, Will the market allow guaranteed renewable? I think the market will.

I think there are some real opportunities in providing the guaranteed renewable premium structure. From a company risk perspective, we think it's preferable. For some companies, guaranteed renewable is problematic, particularly if you have a high expense component. You may have some difficulty meeting state loss-ratio requirements if you have a fairly high expense ratio. For my own company, we thought that offering guaranteed renewable products would increase our options, and we'd have more strategic flexibility. We've kept our traditional noncancellable product in place, and we're coming out with a separate guaranteed renewable product sold only on a loss-of-earnings basis.

Because the market seems to be moving toward guaranteed renewable, we think that having the guaranteed renewable option will enhance our flexibility down the road in case the market moves so much that only guaranteed renewable is wanted.

If you look at most other countries, they do not offer disability income on a noncancellable basis; it's done on a guaranteed renewable basis. These countries have shown the ability to sell DI products on a guaranteed renewable basis. One interesting corollary here is that I think the U.S. market may eventually demand guaranteed renewable premiums. To illustrate this, let me call your attention to annually renewable disability income (ARDI) premiums. They're guaranteed, but what they're guaranteed to do is go up each year. Insureds seem quite willing to come in and pay a lower cost initially, fully knowing that they're going to have to pay more in the future. At the current time, about 70% of our issues have some portion of their contract based on ARDI premiums.

Our strategic flexibility will be enhanced by our new guaranteed renewable loss-of-earnings product. This loss-of-earnings product has an extremely strong link between the benefit and a loss. On a guaranteed renewable basis, we're improving the way we'll sell this product. The underlying product meets a basic need; if you have a disability and there is an economic loss, we'll pay a benefit in relationship to that loss. By offering it on a guaranteed renewable basis, we can compete favorably on a price basis. It significantly lowers the going-in cost.

In terms of specifics, we've improved that link between the benefit and a loss by adding a number of features to this contract. A key element is that the measure of disability is focused on the ability to work. To collect a benefit, the insured has to meet what we call a work requirement. Basically if the insured is able to work in a reasonable occupation as defined by education, training, and experience, then the insured must be working to the capacity allowed to collect benefits. We'll provide the insured with up to six months to try to obtain employment as long as he or she is actively looking. The key point is that if the insured is disabled from his or her occupation, we cover him for that, but he must be working to the capacity allowed to collect benefits. If he didn't have the disability contract, what would the insured be doing? He'd be working.

What we're trying to do is pay benefits based on the loss, and we'll do that through a proportionate benefit formula. We'll pay benefits in relationship to what's lost if the insured is disabled and meets the work requirement. There won't be any type of automatic benefit because he can't work in his own occupation. On top of that, for all insureds and for all occupation classes, part of the coverage will have to be in the form of a social insurance benefits rider. The purpose is to provide a benefit in relationship to the loss. We're issuing coverage at a level that we think is appropriate. So if Social Security pays, then we should pay less, and that's what the social insurance benefit does.

Another feature we will have in this product is a relation-of-earnings clause. Because of regulatory limitations, this clause is not where we think it should be, but it is where we think we can get approval. In almost all states, the clause you have to use basically says that the insurance company may reduce benefits only if the sum of all benefits exceeds 100% of predisability earnings. That's well over what we think is appropriate for issue and participation limits, but at this point, that's what almost all states are willing to approve. It's better than not having the clause at all, but it's not at the level that's appropriate for the company or the insured. If we could lower that relationship, we could lower the premiums.

Another feature is a 24-month mental disorder limit. Our experience on the group side has shown that for almost all disabilities, insureds who receive proper treatment can return to work within 24 months if they have the motivation. We feel this limitation will provide the motivation and cut our costs, thereby lowering the premiums.

The final specific feature of this contract that I'd like to call to your attention is that it will be offered only on a guaranteed renewable basis.

The final message I want to leave you with is this: From my own company's perspective, it's not obvious that noncancellable has to die. However, it is fairly obvious that some changes must be made, and we think we've made many of them. There may need to be additional changes in the future, but the question of whether to offer noncancellable is not as big of an issue as some of the other points that I was trying to make.

MR. SCARLETT: What I think I heard was that, yes, noncancellable DI is viable *but*, guaranteed renewable needs to be added to the portfolio. Our next speaker is Dan Skwire who is an actuarial associate at UNUM, where he is in charge of individual DI pricing.

MR. DANIEL D. SKWIRE: A very interesting article by Peter Drucker, "The Information Executives Truly Need," appeared about a year ago in the Harvard Business Review (vol. 73, 1995: 54–63). In that article, he described how each corporation has its own theory of the business, and this theory is the set of assumptions on which an organization is built and on which it runs its business.

These assumptions can be either very explicit (the sort of assumptions you'd see in a corporate mission statement) or they can be implicit (the sort of assumptions you have about the markets you're in). They underlie every aspect of the business—the way you look at your markets, competitors, and decisions—and they define what you do well and every aspect of your behavior.

Let me tell you about UNUM's theory for its individual disability business during much of the 1980s and the early 1990s. I think this theory conforms very much to what you would see at other noncancellable companies and what we've heard from some of the speakers. First, the individual disability market requires noncancellable DI insurance. If it's not noncancellable, it's not DI. Second, the theory says that noncancellable is a financially viable form of coverage and, in particular, to make it financially viable, you must focus on prudent risk management (which includes underwriting, careful pricing, close attention to your benefits practices, and so on). Third, high-income occupations translate into a high work ethic. For many years during the 1980s, our ideal risk profile for a noncancellable DI contract was the high-income surgeon. Here was someone who invested the most time and effort and training into preparing for his or her occupation, so there was the assumption that this person had the most motivation to get back to work. That's the framework under which we were operating during those times.

The time line in Chart 2 shows a rough chronology of some of the events that have occurred at UNUM during the last year-and-a-half. In 1993, UNUM's individual disability division earned a record $69 million. To put that into perspective, that's about 50%

higher than we had ever managed to earn before in this product line. We were beginning to think that the hard work was paying off and that we'd begun to solve the mystery of noncancellable DI.

CHART 2
UNUM—A TALE OF WOE AND INTRIGUE

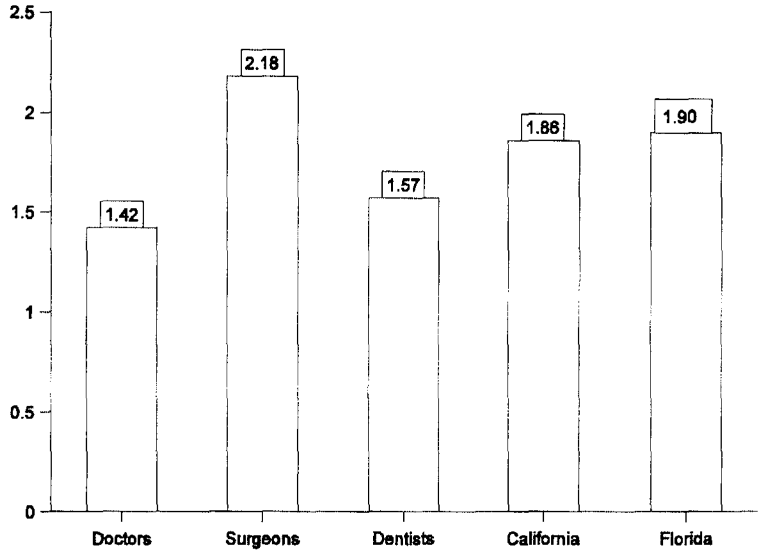
12/31/93	Earned record $69 million in individual disability
1/Q/94 to 2/Q/94	Deteriorating experience—especially on physicians
3/Q/94	Fundamental Review
11/7/94	Reserve strengthening of $192.4 million; announce decision to exit noncancellable
6/26/95	Introduced new portfolio of guaranteed renewable products

Now let me be clear on this point: we were aware at this time, even as early as 1990, of some problem segments in our business. We knew that California was not doing us any favors, and we knew Florida wasn't especially good. We were aware of certain physician specialties that were causing problems, and 30-day elimination periods were not a big breadwinner for us. But we were dealing with some of these problem segments by taking actions we thought were consistent with our theory of the business. These are some of the actions that you heard John and Dave talk about—stricter underwriting guidelines, intensive claim-management practices, and careful pricing, such as price differentials for risks in California and Florida.

In the first quarter of 1994, however, we began to see some significant deterioration in our experience. Incidence rates were heading up, and claim termination rates were heading down. The problems that we were seeing were due primarily to experience on physicians. This experience was a direct result of some of the structural changes that we were seeing in the U.S. as a result of health care reform. The move to managed care, utilization review, and that sort of thing began to result in some declining incomes for high-income physicians and started to lead to some of these problems. If you were to look at our block of business for the first six months of 1994, excluding claims on doctors with a monthly indemnity over $5,000, our incidence rates actually decreased 7% for that period. I think the incidence rates for doctors were up about 60–70%. So that gives you an indication of what the underlying problem truly was.

In looking at this business in the first two quarters of 1994, the question arose, Are we looking at a blip or are we looking at a trend? It was becoming rapidly clear to us that we were not looking at a blip. We were going to have to start finding some real solutions to some of these problems. Early on in the third quarter of 1994, we began a fundamental review of our individual disability business at UNUM. One of the first steps that we took was to conduct some very detailed segmentation studies of our block. We wanted to focus on every conceivable segment, identify where the problems were, and start to find the causes of these problems. Chart 3 shows some results from our segmentation studies.

CHART 3
FUNDAMENTAL REVIEW—ACTUAL-TO-EXPECTED* LOSS RATIOS
DIRECT-BILLED INDIVIDUAL DI (1991–93)



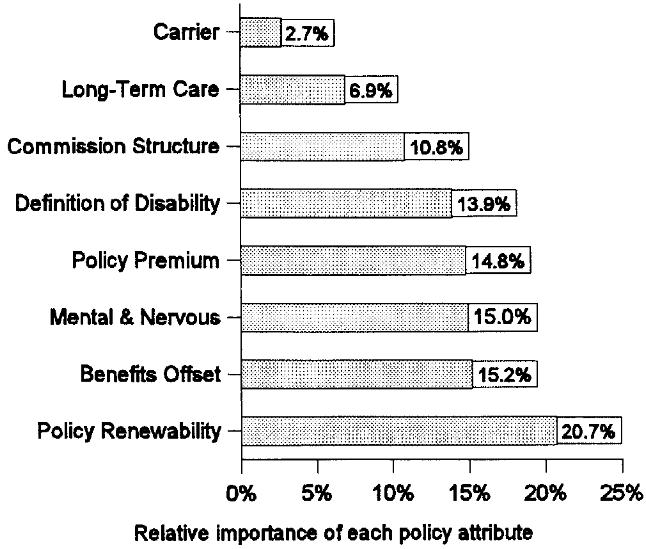
*Expected = UNUM experience 1989–93.

The actual-to-expected loss ratios from 1991 to 1993 were 218% for surgeons and close to 200% for California and Florida. This confirmed many of our worst fears about what the business looked like.

As a second step in this fundamental review, we decided to get a more detailed picture of what the individual disability marketplace looked like and what that marketplace required in its products. So we conducted what we called a "conjoint analysis study"—a survey of large noncancellable DI brokers. We gave them a series of comparisons between two DI policies that would have a number of differences. For instance, one policy would be guaranteed renewable with a two-year own-occupational provision and a mental nervous limit. The other policy would be noncancellable with unlimited own-occupational provision and unlimited mental nervous. Then we'd ask, which would you sell? By using this approach, we could get a picture of which product features were the most important to the brokers in the marketplace. Chart 4 shows the results of that study.

This survey confirmed many of our suspicions about the marketplace, and it also confirmed our underlying theory of the business—policy renewability came up as the most important feature in the marketplace. It is, however, important to remember that we are guilty of selection bias in our survey because we talked to leading noncancellable brokers who have a vested interest in what they're selling. I also found it interesting that commissions turned up so low on the list.

CHART 4
FUNDAMENTAL REVIEW—DI BROKER SURVEY



By using the results of the segmentation studies and the market information that we gathered, we began to develop a strategy to address the problems that we saw in these studies while still working within our theory of the business. It's the type of strategy that Dave and John talked about earlier—reducing blood testing limits, reducing issue and participation limits, and initiating changes in occupation classes—everything other than changing the rate structure. We began to realize that there are many fundamental problems in this business that we were not going to be able to change with this type of strategy. Gradually we realized that we were going to have to look further and that we were going to have to start looking at our theory of the business.

Referring again to the article by Peter Drucker, he says that a theory of the business must fit reality. It must match the marketplace and the reality in the world around you and, furthermore, that theory must be tested constantly. He says very explicitly that patches—things such as changes in issue and participation limits and tweaks in underwriting guidelines—aren't enough. They're not going to solve the problem. He recommends a preventative care approach—every few years, whether you think you need it or not, you take a look at the theory of the business and challenge every aspect of it. However, it was too late for preventative care for UNUM. It came down to one major question: If you were not in the business, would you be entering it now? And that question, more than any other, changed the way we thought about the noncancellable DI business.

One of the things we realized as we started to ask some of these questions is that our problems in 1994 were due to health care reform. But our problems could have been caused by any number of changes to formerly profitable segments. Think about the changes in the legal world—discussion about tort reform, too many lawyers, job dissatisfaction. Poor experience could happen there. Think about accountants. What about some of the flat tax proposals out there in Congress today? This could be the "accountants unemployment act." What if one of the larger states were to introduce some sort of long-term disability coverage that would cover its residents like an expanded cash sickness plan? That could have a huge impact on replacement ratios, with no recourse at all for noncancellable companies. Changes in Social Security laws, changes in tax laws—all these are risks that we face in the noncancellable business.

There are many fundamental problems with the DI products that we've sold in the industry over recent years—problems such as the way we look at occupations and the way we define income. Overinsurance has been a major problem. You heard John say that noncancellable is not the culprit. I'd amend that a little to say that noncancellable is not the only problem. However, I'd still put noncancellable near the top of the list, because it eliminates your ability to respond to all these other problems and to the broader changes going on in the world around us. Let's think about some of these changes for a minute. Consider the case of someone who is 35 years old today and wants to buy a DI policy. There's a good chance that this person is will have a working career of another 30–35 years, so that policy could be in force for a long time. Would you care to imagine some of the changes that might occur over 30–35 years? I took a look at the changes that have occurred in the last 30–35 years to get a feel for what some of these could be. I was amazed by some of the changes that have occurred (see Table 1).

TABLE 1
HOW THE WORLD CAN CHANGE IN 30 YEARS

	1960s	**1990s**
U.S. Population	180 million	255 million
Percentage in California and Florida	11.6%	17.4%
Lawyers/1,000 Population	1.4	3.3
Median Income	$5,400	$30,400
Top Tax Rate	70%	39.6%
Tax on $50,000 Income	$24,000	$9,000
Reported AIDS Cases	0	70,000*

*Data from the Center for Disease Control, 1993.

Look at the change in the percentage of the population living in California and Florida. Look at the increase in lawyers in the population. I think the last statistic, in particular, is interesting. The number of reported AIDS cases went from 0 in the 1960s to 70,000 in 1993. Just the list of new diseases alone is amazing. Diseases that didn't exist in the 1960s—chronic fatigue syndrome, lyme disease, posttraumatic stress disorder, repetitive use problems, carpal tunnel syndrome—are now factors with which we must contend.

This is the environment in which we're operating, and this is the environment in which we're selling noncancellable DI. Now I don't think you'll meet too many actuaries who will say with any confidence that they can predict the future. It's impossible to anticipate these sorts of changes over the long term when designing contracts. You can only hope that the margins you use when pricing noncancellable DI will be sufficient to cover unanticipated changes. You can also attempt to address some of the problems by changing contract features. But as we've discussed, these are very difficult changes to make in today's regulatory environment. The fact remains that no matter how effectively you address issues, such as overinsurance, you're still facing this kind of change, and you're still facing the new diseases and demographic problems that you're going to have no ability to respond to. If your rates are noncancellable, there's nothing you can do about it when these changes happen.

So this is the type of thinking that led to two key announcements made by UNUM in November 1994. The first announcement was that we would be strengthening our claim and active life reserves by a total of $192.4 million pretax, and the second was that we would be exiting the noncancellable DI market and searching for some other DI product solutions which would, among other things, retain the flexibility to change rates in the future.

Just yesterday we released a new DI product that is guaranteed renewable. It is very different from other products in the marketplace. This product will be replacing the noncancellable product. It is our ultimate acknowledgment that the theory of the business that we held throughout the 1980s and early 1990s no longer fits reality and that the time has come for major changes.

So far I've focused on the point that I do not believe noncancellable is viable, but I haven't offered many alternatives. In particular, I haven't talked very much about guaranteed renewable. Guaranteed renewable is not the ideal solution to the problems we face these days. With the regulatory environment in the U.S., it's not even close. I was glad that John mentioned the Paul Revere *Market Watch* article. I took a look at that in preparing these comments.

John talked about some of these criticisms of guaranteed renewable disability income, so I'm going to quickly go through them. One, there may be a temptation to relax risk management. In other words, there may be some tendency to take on worse risks and relax underwriting standards because there is the flexibility for rate changes in the future. Two, guaranteed renewable has a higher minimum loss ratio, generally 5% higher than noncancellable. What are the implications for the returns that you can earn on the business, commissions you can pay to producers, and the resulting effects on sales? Three, rate changes for guaranteed renewable policies are accompanied by their own problems. You are faced with regulatory issues—getting rate changes approved by each state—and the potential for lapsation and assessment spirals if you start raising rates. Finally, what's the market appeal of guaranteed renewable business, and what sort of rate differential does the marketplace demand to make a guaranteed renewable product attractive? These are big issues and they're issues that take away from the appeal of guaranteed renewable insurance. We did not go blindly into the void of guaranteed renewable and say, "Oh, my goodness! What are we up against?" These are issues that we addressed head-on in our new product, and I'm going to take you through these issues one by one and tell you how we've addressed them in designing our new disability product.

On the risk management front, I think it's imperative that guaranteed renewable be priced and administered like noncancellable. You cannot assume a rate change when you are pricing guaranteed renewable business. The flexibility to change rates should be viewed as an escape hatch; in other words, as a tool you can use when the experience is poor. It is crucial to remain vigilant in your underwriting and benefits practices. Our new contract is stricter in many ways than our old noncancellable contract.

With respect to minimum loss ratios, it's not difficult to see that a higher minimum loss ratio, with all else equal, is going to mean a lower profit margin. In a stable environment, guaranteed renewable will perform worse than noncancellable simply because of the loss ratio requirements. That's probably true even in an environment in which morbidity is increasing slightly, say 10%, over a series of years. But think a minute about those actual-to-expected loss ratios I mentioned earlier. Those are big segments. In California, our number-one state in sales for years, we're looking at an actual-to-expected loss ratio of 190%. And for surgeons, another target market for years, the actual-to-expected loss ratio is 218%. We're not talking about incremental worsening of morbidity trends. I think that this is very consistent with the escape hatch interpretation of guaranteed renewable. If we see changes such as that, you will come out further ahead with the guaranteed renewable product form.

On the issue of rate changes, yes, it is difficult to administer rate changes. You will probably not be able to get rate changes through all 50 states in a timely fashion. However, I think there is much more awareness now in the regulatory world that there are problems in the DI marketplace. I think there is an awareness that many product forms out there are inadequately priced and changes need to be made. You may have to settle for most states, and you may have some tricky arguments to make, but I do believe it is possible to get rate changes approved.

A more delicate issue is the question of lapses. It is too simplistic to say that raising rates on in-force business will automatically put you into an assessment spiral. I think you must look very closely at the policyholder's options. Let me give you an example. Consider a surgeon with a 30-day elimination period policy that he bought ten years ago. This surgeon lives in California and has been crushed by health care reform, so the benefit on the policy now exceeds the income that the surgeon is earning. I think this is a block for which we'd have an easy time justifying a rate increase. What are the other options for the insured? He's not going to be able to buy 30-day elimination period DI insurance anymore. He won't be able to buy as much coverage as he has now. He won't be able to buy it at the original age, and he won't be able to buy it at the rate that we sell in other states. So even for healthy in-force lives, the best alternative may be to remain with the current policy. Furthermore, insureds are used to increases on other types of insurance. Premiums for auto insurance, health insurance, and so on, increase year after year. Certainly we're not looking at that sort of mechanics in guaranteed renewable. But it does seem to indicate the insured's willingness to accept rate increases.

Finally, there is the question of market appeal. The claim has been that guaranteed renewable rates must be 15–20% cheaper if all else is equal. Our approach at UNUM has been to design a product without all else equal. We did not want the policyholder to be choosing guaranteed renewable or noncancellable based simply on a price differential. We've introduced an entirely new product so the choice will be between two completely separate product portfolios with many differences, one of which is the renewability provision of the rates. I think there's room in the market, as well as a big need, for innovative DI products. We've done a great deal of work in the past ten years selling the market on noncancellable, so I think maybe it's time to start selling them on guaranteed renewable.

So back quickly to the question of the day, Is noncancellable DI viable? I'm going to go back to the very important related question that I raised earlier. If you were not in the business today, would you be entering it now? Think about the question and think about what you've seen in the industry in the last five years—think about the exits, private label arrangements, consolidation, and the number of new entrants into the noncancellable DI market.

Make no mistake; at UNUM we do not believe that guaranteed renewable is an ideal solution. It's not fun, it's not easy, and it introduces many new headaches. But unlike noncancellable, guaranteed renewable is a viable means of dealing with the changes we've talked about, from taxes to new diseases to earning patterns to demographics. At UNUM, we spent the last 18 months agonizing over many of the questions we've discussed, and for the reasons I've explained, our answers to those questions are no, we would not enter the noncancellable DI business and, no, we do not think that noncancellable DI is viable for the future.

MR. SCARLETT: I think Dan's message was clear. Not only is noncancellable DI not viable, it's probably foolhardy. So we have quite a range of opinions on the panel.