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Session 7PD
The Future of Individual Disability Income

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Summary: Trends in individual disability income (DI) are discouraging. Profitability has been poor. The number of new policies sold has been declining, and companies have had difficulty penetrating new markets. This session will address whether the DI industry is effectively dealing with these issues:

- *What is the outlook for DI profitability?* Is the profitability of new sales likely to meet company profit objectives?
- *Do current product forms meet the needs of the consumer? Do they provide good value for the consumer's dollar?*
- *What changes, if any, should be made to*
  —products?
  —distribution?

Mr. Michael B. Koopersmith: It is certainly no surprise to anyone in the audience to say that trends in recent years in individual DI are discouraging. It is an understatement to say that profitability has been poor, but lack of profits is only one area where we have problems. The number of new policies sold has been steadily declining for many years, and companies have had difficulty penetrating new markets.

Chart 1 shows the trend in incurred claims for the top nine noncancellable companies that have been tracked by Milliman & Robertson (M&R) since 1980 and reported on in M&R's DI newsletter. These nine companies account for almost 70% of the noncancellable DI industry's in-force premium.

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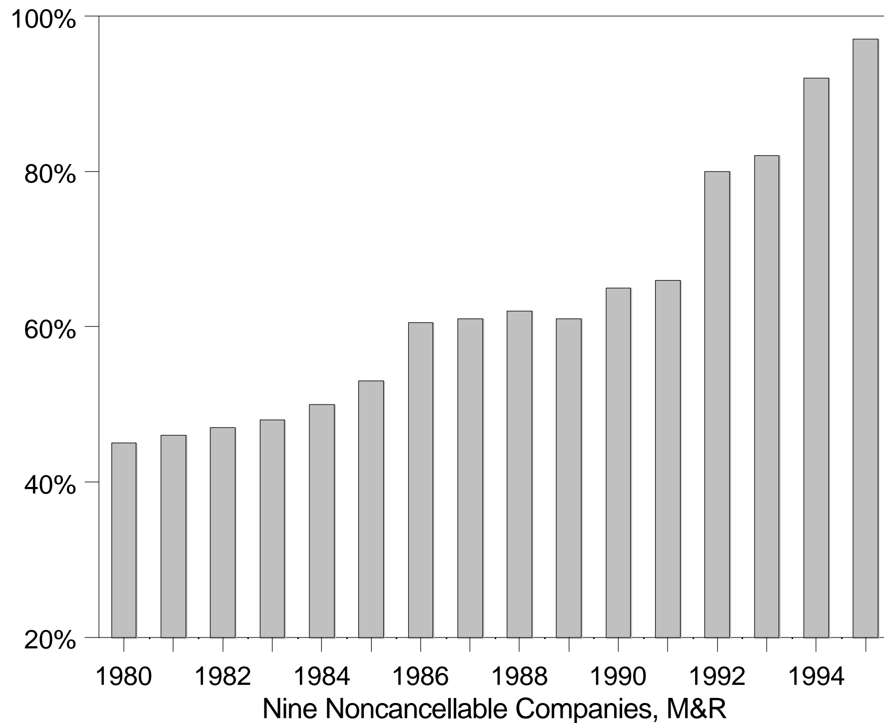
CHART 1
DI INCURRED CLAIMS



Incurred claims have more than doubled! Incurred claims rates were in the 40% range through the early 1980s. Incurred claims are now running in excess of 90% of premium.

Much poorer than anticipated recoveries have been a major problem for all of the companies I talked to. The jury is out on the degree to which claim incidence rates have deteriorated. The sources of the problems have been well documented, and I do not plan on going into them here.

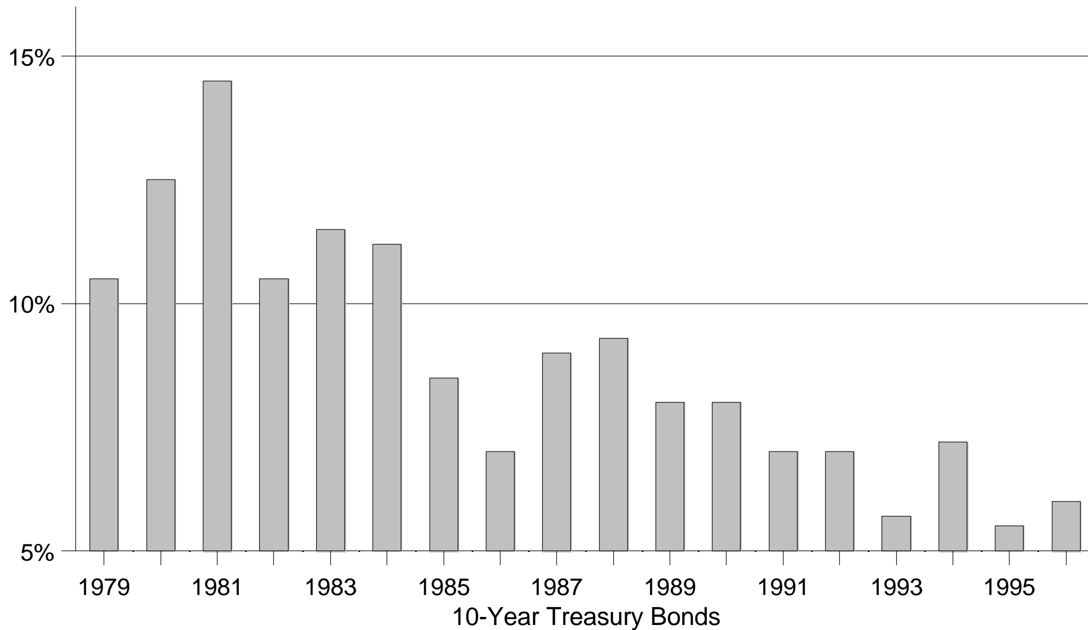
And 1996 results should be available shortly and, based on some preliminary data that I have seen, 1996 looks like it will be worse than 1995. This is due, in part, to Paul Revere's $380 million reserve strengthening concurrent with its acquisition by the Provident Companies.

This does not present a pretty picture. It is not just poor morbidity experience that has been a problem. Lower investment yields have had a major impact, too.

Chart 2 shows the trend in yields for ten-year Treasury bonds, which is not a bad surrogate for the trend in new money rates for most companies' bond portfolios.

Interest rates were in excess of 10% through 1984 and have been generally on a declining path since then.

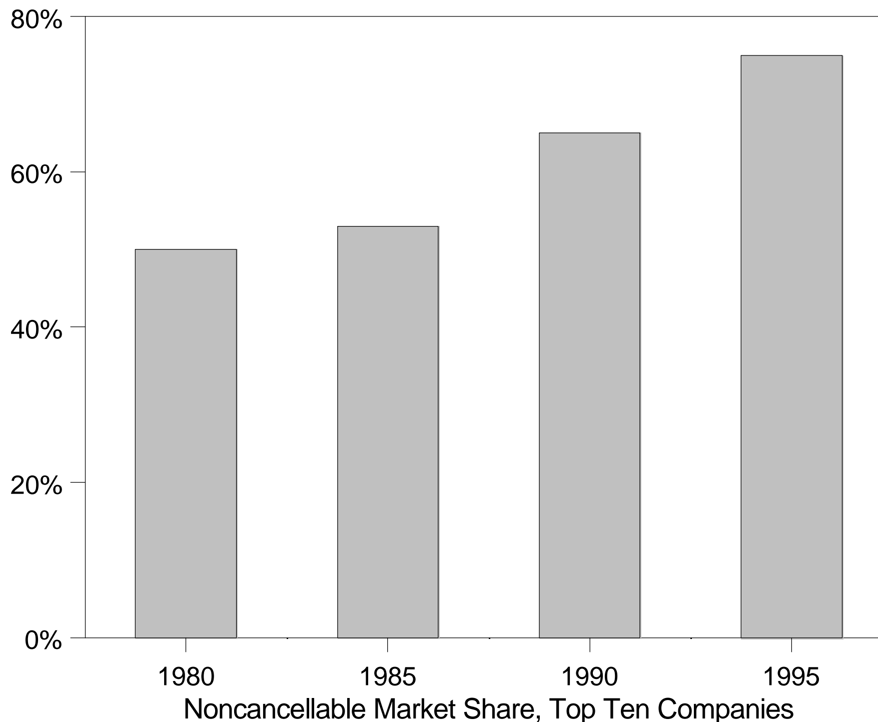
CHART 2
INTEREST RATES



As a rule of thumb, a 1% decline in interest rates, that is, 100 basis points, impacts claim reserves by about 5%. So you can see that declining yields have had a major impact on DI reserves and company financial statements. Given the trends in claims and profitability, it should not be surprising that the DI industry has been consolidating.

Chart 3 shows the trend in market share of the top ten noncancellable DI companies from 1980 to 1995. The combined market share for these ten companies was 49% in 1980, 53% in 1985, 69% in 1990, and 76% in 1995. So you can see that the DI industry has been consolidating for a long time. There are several reasons for this.

DI is, in the words of some investment analysts, a high-value-added business. This means that risk management—underwriting, claims processing, and consultative resources (like field claim representatives, accountants, and physicians on staff, and other specialized expertise) are all very important. You need a skilled actuarial staff. And you need large volumes of business to support your infrastructure and gain economies of scale. That is why market share is important and why the DI industry has been consolidating.

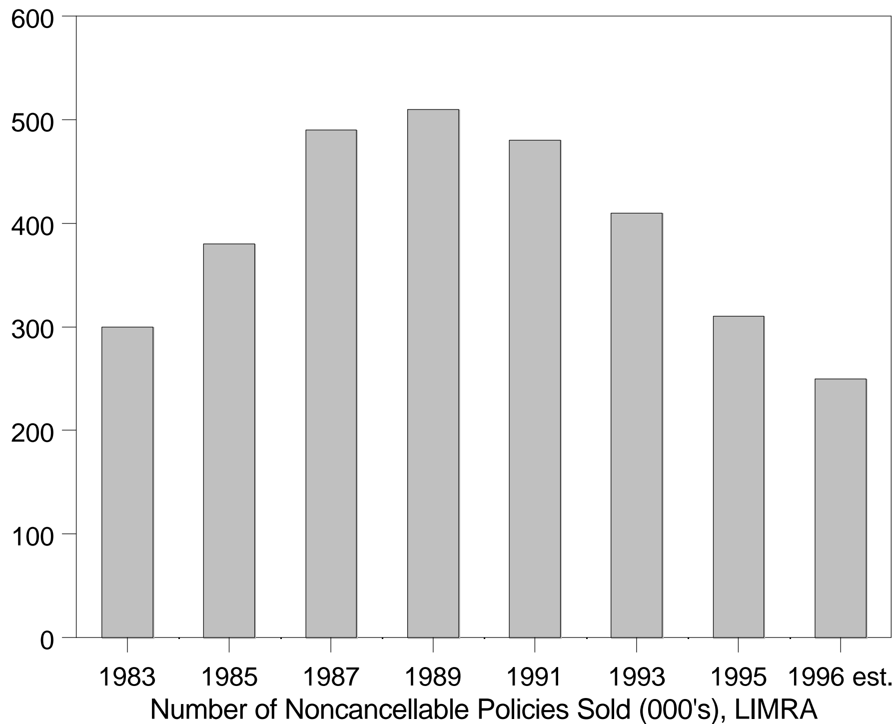


But being big does not guarantee success. Over the past four years, these same ten companies have had in excess of $1.5 billion in charges to earnings from their DI operations. Actually, the number is a bit over $1.6 billion, if I added it up correctly. In fact, if you look back at the ten companies at the top of the list in 1990, only three are still selling noncancellable. One has switched to guaranteed renewable (GR). Two companies have been acquired, and four have simply stopped selling individual DI insurance.

As I said, being big does not guarantee success. Chart 4 shows you the trend in noncancellable DI sales from 1983 to the present, as measured by the number of policies sold. If we were looking at the total new business premium, we would see a somewhat more attractive pattern, because the average price per policy sold has increased. And for those of you who track the DI marketplace by looking at total earned premium in force, you would see that while the growth in in-force premium has slowed, it is still increasing. But this increase is a result of improving policy persistency, not growth in new DI sales.

It is not surprising that sales have slowed recently as companies have tightened contract language and underwriting rules and increased rates. But what was surprising to me when I saw this data for the first time was that the number of policies sold began declining in 1990, before the current tightening took place.

CHART 4
NONCANCELLABLE DI SALES



Now, don't get me wrong. The industry has been making money, and higher prices, tighter products, and underwriting to improve profit margins were necessary. However, what these data indicate is that the decline in noncancellable sales has more to it than just the tightening that has taken place in the last few years.

What, if anything, does this information tell us about the liability of our current product offerings? What good does it do to offer a profitable product that the marketplace does not find attractive?

I am glad I have two experts to call upon who can make sense out of all of this. What is going on in the industry, and have we effectively dealt with our problems? Is individual DI a viable business?

At this point let me turn the panel over to the first of our panelists, Dan Skwire. Dan is a second vice president in the Individual Disability Division of UNUM Life Insurance Company in Portland, Maine. Dan has been with UNUM since 1991, and his current responsibilities include pricing, product design, and risk management for UNUM's individual disability portfolios in both the U.S. and in Canada. Dan has been a frequent speaker at Society meetings and other industry groups. His research paper titled, "Actuarial Issues in the Novels of Jane Austen,"

appeared in *The North American Actuarial Journal* in January 1997. In his spare time Dan belongs to the board of trustees of Greater Portland Landmarks, a local preservation group.

Mr. Daniel D. Skwire: It is a truth, universally acknowledged, that the individual disability industry has been in a terrible struggle of late. The folks at Milliman & Robertson's *Disability Newsletter* have done a wonderful job of documenting that. I think there is tension among disability actuaries at this meeting as we await the annual publication that will tell us just how bad the struggle has been in the past year.

I was on a panel discussion, that Dave moderated about two years ago, which asked the question whether noncancellable DI was a viable product. And two years ago I said that the answer was no, and I still hold that opinion. I think the question that we are addressing, however, is a little bit broader. The question is whether individual disability has a future at all, whether the product in and of itself is a viable product. I think that is an easy question, and I am going to give away the punch line here and tell you that I think the answer is yes.

I think right now we are in a period of unprecedented need for individual disability insurance. And it is up to us as the insurance industry to figure out a way to make a profit on this business. Now what do I mean when I say we are in a period of unprecedented need for individual disability insurance? Let us take a look at a few economic and demographic trends.

In the last 15 or 20 years we have seen a real change in the way people save money. In 1980, we tended to put our savings into passbook savings accounts, into certificates of deposit, into very conservative bank investments. In the late 1980s, and moving into the 1990s, we have seen a really explosive growth in mutual funds. They are probably the savings instrument of choice these days. That is an interesting trend, because it creates some new risks for people with their savings. And the other trend is a decrease in the overall amount of savings. That creates risks of another kind: the risk of outliving your savings and your income.

And, at the same time, we have seen an increase in the overall levels of household debt, as a percentage of disposable income. We are at record levels now. Complicating this is the fact that much of this debt is financed at market interest rates. Things like home equity loans, adjustable rate mortgages, credit card debt—these are all variable interest rate kinds of financing for your debt. So there is build up and variance on the expense side of the equation.

At the same time there is more and more variance on the income side of the equation. The income variance comes from a couple of different things. It comes from the fact that the work force is more mobile. There seems to be less job security these days. Even for people who have some degree of job security, we're seeing employers increasingly adopt incentive pay schemes. Larger and larger portions of pay are incentive based. Stock options at one point were a very highly leveraged form of compensation available only to the most senior executives. Those have become quite widespread in corporate compensation now. They are very common in the high technology industry. This is all evidence of increased uncertainty on both income and expenses.

Employers face similar problems. They have seen the cost of benefits as a percentage of payroll nearly double in the last 30 years. Employers need to cope with these trends. It really boils down to shifting either cost or risk back onto the individuals who are covered by these plans by using deductibles, coinsurance, and cutbacks in certain types of benefits.

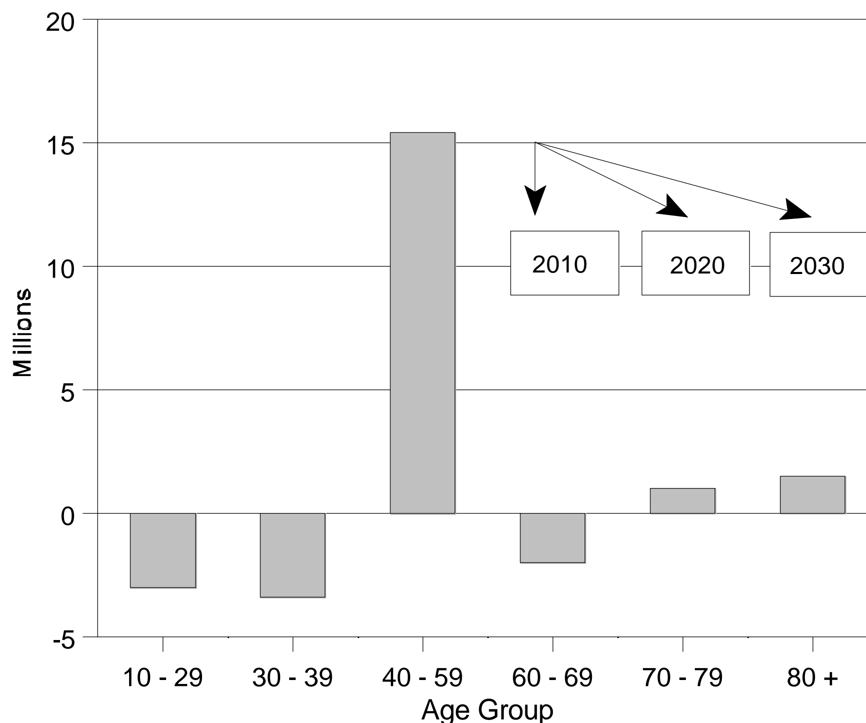
We know about the build up in defined-contribution plans. In 1980, about one-third of all contributions to pension plans went into defined-contribution plans. That is currently running about three-quarters of all contributions. There are a couple of different risks that lie buried in this change. The most obvious one is the investment risk that individuals now bear. The amount of one's retirement income will go up or down based on the performance of the invested assets. But the second risk is that individuals are now making a choice about whether to contribute at all into their pension plans. That is a very significant risk for individuals in their financial planning.

And while we are on the subject of retirement plans, this is a reminder about a little demographic phenomenon called the baby boom. Chart 5 shows population change in the 1990s broken out by age group. The boom is now at ages 40–59. As the decades go on, that boom is going to move a little bit further out on the spectrum. It will not be long before the demographic picture of the U.S. as a whole looks quite similar to the demographic picture in the state of Florida today. It is going to be a real change for us as we get used to some of these demographic trends.

We have gone from about 40 workers per recipient at the inception of Social Security down to about three in current times. And we are staring two right in the face. There are only a certain number of options for dealing with this problem. One of them is to double the tax rates over the next 20 years. That is not a really appealing option. But I think the alternatives to that are very much the same alternatives that we saw employers exploring because of their increased cost of

employee benefits. It boils down to shifting the costs or shifting the risks, whether that is means testing, increasing the eligibility age, and so forth. Something needs to happen here, and I think we will see that coming.

CHART 5
U.S. POPULATION CHANGE BY AGE GROUP
1991–2000



Now that is a lot of the different economic and demographic kinds of trends that we have looked at, and they have all shown mostly the same thing. Whether you are looking at banks, employers, governments, and social insurance programs, it all translates into an enormous shift of the financial burden from these institutions onto the individuals. The world is becoming a riskier place for individuals. We are at a time now where individuals have amazing levels of financial risks being placed on them by all these other institutions. What a perfect time for insurance companies to step in with individual insurance products designed to relieve these risks. That is what I mean when I say that it's a period of unprecedented need for individual insurance coverages.

The opportunities we have in the individual disability market extend beyond just this risk-shifting phenomenon. I want to take a look at a couple of other demographic issues. The U.S. has always been a diverse nation. We often view other cultures in terms of interesting foods, the different kinds of music and things that we are exposed to by interacting with these other cultures. But something that

is often overlooked is the economic power that is tied up in people from other countries: $650 billion of purchasing power. Twenty-five percent of the U.S. work force will come from these groups by the year 2000. They are eyeopening numbers. They really indicate the amount of new knowledge and experience and perspective that is going to be coming into the U.S. work force as a result of these changes. But as companies whose business means meeting the needs of the average working people in America, we have got to be on top of this. We have got to be prepared to meet a set of needs that are very different from anything that we have dealt with before. We are going to be dealing with different languages, with different cultures, with different communities, and it is going to be a significant challenge for us. It will also be a very good opportunity for the companies that can meet that challenge.

Another demographic market that we are going to have to think about is known as the baby bust-slacker-alternative music crowd: Generation X.

I think I would give the two about an equal probability. Generation X is an interesting group. It is accustomed to job insecurity. There was an article not long ago in *The Wall Street Journal* that said that now the number one employer in the U.S. is Manpower, the temporary help agency. You now can hire nuclear physicists through Manpower. Many people who work at Manpower are Generation Xers, people with college degrees. That sort of job insecurity contributes to the fact that Generation Xers are a little bit distrusting, mobile, and self-reliant. And think about that: distrust, mobility, self-reliance. Those are fairly good characteristics for people who might need individual types of insurance, individual disability insurance. We need to figure out the right kind of products for these markets, the right kind of ways to market to these people, but it is certainly an opportunity for us.

I want to give you a couple of quick highlights for how we are trying to deal with some of these demographic and economic issues that we have seen. One way is we are trying to design products that will be attractive to the different segments that demonstrated these demographic opportunities. When we look at the aging population, we put an increased focus on long-term care. We have tried to build connections between our individual disability products and our long-term-care products to try to have more appeal for that market. We have tried to make inroads into what I will call the multicultural kinds of markets. We have created a unit recently that is geared towards finding new products and marketing solutions. And we are also trying to reach Generation X through a combination of new products, new marketing techniques, and new kinds of technology. Generation Xers all love the Internet, so there are interesting opportunities there to reach that market. We are using technology in other ways. We are trying to find ways to help brokers with

the enrollment process and to find easier ways of gathering information in the underwriting process.

We are also trying to blur the lines in many cases between individual and group insurance. On the group side we are recognizing that we are a more mobile population. There is an increased need for portability in our products. There is more desire for individual choice within a group disability kind of construct. And on the individual side we are also constantly searching for different kinds of connections for individuals that can help both on the risk side and the marketing side. Those areas might be through an employer, through an association, or through all sorts of other forms of connections. We are trying to take advantage of those connections in marketing our products.

There is a need to maintain the balance of risks between the insurer and the policyholder. We said that our mission is to relieve insurable financial risks. We are not going to write fire insurance while the house is burning down. We do not write noncancellable disability insurance anymore at UNUM. We view that similar to writing a put option for the policyholder. When the experience deteriorates they can all get put right back onto the insurance company. We think that there are clearly opportunities for significant risk relieving without doing it with a noncancellable rate structure.

And, finally, we put significant emphasis on efficient use of capital. That can come up in many different ways. Disability is a very capital intensive business, and it is very expensive to put business on the books in disability. It comes from underwriting costs and policy issue. It comes from commissions, especially the strain of high/low kinds of commission scales. In many cases, like the commissions, the problem is not necessarily the dollars that we spend, but the way in which we spend those dollars.

Other capital issues that are a little further beyond our individual control, but which are more industry issues, would be things like statutory reserve requirements, required capital formulas, other issues that lead towards the capital intensity of the business. We should constantly be researching these kinds of issues, and moving forward and making progress on them.

Well, I said at the beginning that I thought this was an easy question—whether disability was viable or not. I have given you a long answer to an easy question, but I do think that this is a viable market. I think it is an exciting market to be in. I say that not just as an actuary, but also as a Generation Xer.

I bought an individual disability policy just a few weeks ago. And the reason I bought the policy was for many of those same issues that I mentioned previously about Generation Xers. I am distrusting. I do not trust my employer to keep the same levels of insurance coverage in force forever. I like the words "guaranteed renewable" on the coverage page of my policy. That means that no one can take that policy away from me. I am not sure whether I will work at my employer for the rest of my career, and if I decide to leave I want my insurance policy to go with me. That is an assurance I do not necessarily have if I am relying on different employers and group coverages. The individual policy form has a lot of appeal for me as a Generation Xer.

So let me close with a quick lesson here. I had a history professor in college who told me if you want to know if someone's telling the truth, you look at what they do with their time and money. I have just decided to spend my time in the middle of the desert surrounded by 1,100 actuaries and to spend my money on a disability insurance policy. So rest assured I am sincere when I say that whatever the M&R disability survey may show, and we will know soon, I still think it is a great time to be in the individual disability market.

Mr. Koopersmith: I would now like to turn the program over to Dave Simbro. Dave is a senior actuary at Northwestern Mutual Life. He became a Fellow of the Society in 1987, and has worked in several areas at Northwestern Mutual since graduating from the University of Iowa in 1983 with a degree in actuarial science. Dave's current responsibilities include managing product development, pricing, contract drafting, and filing for individual disability; managing product development for group disability; and leading product research and development for long-term care. Dave has spoken at numerous meetings and has published several articles dealing with DI products and financial results.

Mr. David W. Simbro: What I want to talk about is financial results for new issues. The basic question that arises from that is, is the glass half empty or half full? And while Dan was much more to the point and had an opinion, I am just raising the question. It depends upon how you look at it and the angle at which you look at the financial results for new issues. If I can leave you with the impression that I have all the answers then I have done a bad job. I certainly do not. If nothing else, I hope I can raise a few thoughts in your mind regarding DI.

In terms of looking at the financial results for new issues, it depends upon what segments you are viewing. There are two different issues to think about. Within the medical markets the basic question is, have past changes that have been made by various companies in the DI industry been enough to lead to positive results on the financial side for new issues? Separately, within the nonmedical market, although it

is fair to say for most companies that the financial results have been fairly favorable in this segment, has it just been random luck? Is it susceptible to the same problem? The answer is, it depends. We have to analyze the issues with each market differently.

We view all occupations other than three very specific ones (optometrists, veterinarians, and pharmacists) as being part of the medical markets, a rather homogenous segment of business. Our next two largest occupational categories are significantly smaller. We have twice the exposure in the medical markets as we do with administrators, and administrators do not represent one simple group of employees. It ranges across all kinds of skill and job levels in many industries. And we have four times the exposure in the medical market as we do with lawyers. So it is a very significant segment and the risk there is very different than in other segments.

In trying to predict what the financial results may hold for new issues in the medical market, the real wild card is the future influence of managed care. Every indicator that we have points towards managed care as the force that drove dramatic changes in the financial results for medical market business. And so to get a handle on what the future holds, you have to have a fairly solid understanding of what managed care did and where managed care is going.

To get a quick feel for the historical impact, there are three key things I think that managed care did to the medical market that influenced the DI results in that market. First, it shifted the demand for services to primary care. But when you look into the numbers, the more interesting fact is that hardly any physician group saw the dramatic increases in income that were occurring. And the incomes for all physicians were either leveling off or declining. There was a reduced utilization and growth in fee income for all physicians, not just the high-income surgeons. And it has had large impacts on the financial results.

In 1992, when there was a big push of managed care, results took off on the poor side in the medical market. Since then they have been at a very high level.

Looking forward, there is a very telling source of information regarding the future of managed care. This comes from an American Management Association publication called *The Source Book of State Managed Care Trends and Federation Initiatives*. There are two key statistics that jump out from that. One is that managed care has certainly changed many physicians' lives. A large percentage of physicians now have at least one fee-for-service contract. In 1995 it was at 83%. But in 1994, the most recent data that were in the book, there are very few states where large concentrations of physicians' incomes are coming from managed care. So I think

the point is that the impact of managed care certainly has not worked its way through the system. There is still a large potential impact of managed care on the DI results for the medical markets.

With that, one could certainly look at DI and say the glass is half empty, that the future trend of morbidity results in the medical market are, at best, unpredictable, and that there is a significant concern about issuing new business in that market. On the flip side, one could reasonably draw some conclusions that the glass is half full. There are a number of things companies have done, or could consider doing, that have shown some positive signs.

I am not going to go into much detail concerning product changes. I am sure most of you are quite familiar with these, but there are all kinds of things that can be done, or have been done, by companies to try to influence the financial results. One fairly powerful one is linking the benefit paid to the income lost. There are all kinds of data to support the impact that can have on morbidity trends. Another one is obtaining more cost and benefit adjustability. Dan alluded to one with guaranteed renewable coverage. There are some state hurdles to get over, but there are opportunities with having more benefit adjustability down the road. If you think about it, it does not make much sense from a risk standpoint to guarantee, at issue, some level of coverage when someone's earnings could fluctuate dramatically 30 years down the road. On the group side, contracts continuously stay linked with earnings, and it would make sense to have that type of arrangement on the individual side. Replacement ratios, the amount of coverage issued at time of sale of the contract in relationship to earned income, can have a significant impact on rates of claim. And there are opportunities with replacement ratios, certainly to influence financial results.

One key issue with any product change is to be mindful of regulatory and market hurdles. I think relying solely on GR coverage as the savior for future results has a fair amount of risk to it. If you are dependent upon states' approval for changes and do not have other things in line, you could be in for quite a surprise down the road.

Another issue, in terms of the glass being half full, is that there are various ways to transfer the risk. There are opportunities out there with reinsurance. Comarketing arrangements are possible if your company has concluded it no longer wants to be involved with that risk. There is the issue of diversification; that is, how much of a concentration of risk do you want in any one occupational segment?

The final point is that there are issues with alignment of insured and company interests. If you think about the basic premise of DI and compare it to life

insurance, there is such a dichotomy between the two in terms of the interests of the insured and the company. With life insurance, almost everything is in sync; it is also a product that has fairly large margins in it. Here is a product where the interests of the insured and of the company are not in sync very much at all. The product has much lower margins than most companies are operating on. It makes you question the logic of that.

I want to switch to the nonmedical market. Here, the picture is very different. Again, the basic question to ask is, what is the predictability of financial results in this segment of business? Here, one could reasonably feel that the wild card is, again, the potential for some type of external force to influence the results similar to managed care. There are some obvious issues that could occur: another depression, some type of tort reform and the impact that could have on legal occupations, and some type of flat tax and the impact that could have on the financial community. One basic issue is that companies have much less concentration in any other occupations than in the medical market, so there is certainly a different risk picture here. Beyond that, it is reasonable to question whether the occupational hazards presented by occupations outside the medical industry are just as different as within the medical industry. For a fair amount of medical professionals, the occupation itself is fairly labor intensive. I have heard some people using the analogy that they are extremely highly-skilled mechanics. It is a physically demanding job. Many physicians are on their feet constantly.

Another very practical issue is that there is simply much less awareness of the underlying symptoms in other occupations. People in the medical market deal with sickness every day. I think they are much more in tune with illnesses. When there is some type of shock, such as managed care, they may be much more aware of the underlying elements.

In terms of past results in the nonmedical market, we continue to have fairly stable results, and quite good results, in the nonmedical markets. However, one could still step back and say the glass is half empty. There is risk here. Why wouldn't you consider making the same changes to this market that you do with the medical markets?

I would advise you to be careful with the nonmedical markets. I think it is reasonable to balance any changes you have made, or are considering making, with the demands of the markets. The basic point is that it is critical to define the needs and make sure you have satisfied them. But you do not want to go so far as to protect only the company's interest so that you have not satisfied the basic needs of the insured. At that point you would see sales declining and declining. It is reasonable to think, would you even be considering making changes in this market

if you had not seen the results in the medical markets? Would you have any indicator or feelings that changes were needed? Using the competition as a measuring stick for changes in this market is at best tricky. This is an extremely fragmented market. Each company is going its own way. I would seriously advise each company to think about what makes sense for it and not to get too caught up in what other companies are doing.

With respect to future direction, I would like to leave you with two thoughts. You should look at the two markets differently. There are just different risks, and they may have different needs. To go about satisfying those you should come up with solutions that fit for at particular segment, but not apply them broadly to the entire segment of business. And the other point is to use your past experience carefully. Do not forget it, but do not be tied to it.

Mr. Koopersmith: We have many common themes among our panelists. One thing I would like to do before I get into any substantive comments is to go back to a word that each of us has used on a couple of occasions in our remarks: viability. I think there are many people, many companies, perhaps some people in this room, who would be very happy at this point in time if their disability business turned a profit. And it is perfectly understandable, it is perfectly reasonable when you're in an environment where you have been losing money. They would be happy with a positive blip in claim experience and, again, that is very understandable when the experience has been going the wrong way for a number of years. But making money on this business is not, in and of itself, enough to consider this to be a viable business. Every single company has some kind of a growth objective. Some businesses are intended to grow faster than others. All companies have profitability objectives, and different companies have different targets and different measures. But in order for any business to be viable you need to have some attractive, sustained rate of growth over an extended period of time, as well as an attractive return on investment. It is reasonable to have a couple of down years. If sales take a dip as you take corrective actions, that is certainly appropriate. But, again, viability is measured by the test of time. You need to have sustained growth and sustained profits at a reasonable level of return on investment in order for a business to be considered viable.

With that in mind let us look at what the industry's response has been to the financial issues in recent years. We have seen sharply higher prices, in some cases 50% or more, maybe even 100% in those situations where people have been in lower occupational classes. Underwriting has become much tighter, more restrictive. Contract language has become tighter. There is a trend toward GR contracts. In addition to the contractual changes and underwriting changes, companies have focused significantly on the claims department. The reality of the

situation is if you want to improve your financial situation today, all the new product development and pricing changes are not going to help you. Those are deferred rewards. The only thing that you can do that will have an immediate impact is to reduce costs, either expenses or claims. Companies have added a significant amount of resources to their claims department in recent years. There has been extra focus on the problem areas. In some cases, companies have solved their problem simply by getting out of the business. They have decided that for any one of a number of different reasons, this is a business that does not fit within their organization. The industry response is predictable and appropriate. It is consistent with what the industry has done in similar time periods in prior years.

If the industry's response was predictable, what about the response of the producers to the changes that have taken place? That was also fairly predictable. Their feeling is that increasing products does not provide good value. When you talk to a producer about a noncancellable product, invariably they will tell you it is much too expensive. Their clients just do not want to pay that kind of money. And, interestingly, the clients that are willing to pay the higher prices are not necessarily the risks you want to assume.

We talked earlier about the fact that the alignment of the interests of the insured and of the company are not always one and the same. If somebody is willing to pay a lot of money for an insurance product maybe they know something you do not know.

One of the criteria for this business to be viable is to have an affordable product with wide market appeal. You get a much better cross representation of market risks when you have a product like that. When you talk to producers about GR products you run into two kinds of producers. You have the producers that have only sold noncancellable, only want to sell noncancellable, and they will not even think about GR as an option. But you have some other producers who are at least willing to give you the benefit of the doubt, but they are anything but convinced that a GR product is in their client's best interest. Producers also feel that too much underwriting is required and that underwriting is too conservative. The result may be to jeopardize that producer's relationship with his or her client. Make no mistake about it—the producer's first loyalty is to his client. His second loyalty is probably to himself. His third loyalty might be to his carrier. From the company's perspective and the actuary's perspective, capital costs are too high, the product is too expensive to sell and underwrite. It is too capital intensive and companies are looking for ways to reduce commissions. However, many producers will tell you that given the amount of extra work that is required to sell the product, go through the underwriting process, and place it, the commissions are inadequate for the extra time and effort required. And in some cases they simply say there has got to be an

easier way to make a buck. Fewer and fewer producers are selling disability insurance, and it is because of those reasons.

Another reason is replacement ratios. Despite all the contractual changes that have taken place, and the underwriting that has taken place, replacement ratios are much, much too high. If you look at the limits in Table 1, you will see that there was some reduction from 1985 to 1990, but since then there has been very little movement in replacement ratios. Combination limits are fine if you are a producer, but they are not fine for the company. There is ample evidence to show that when replacement ratios get up over 50% or 60%, you begin seeing signs of higher-than-expected morbidity. When you go well up into the six-figure incomes, $200,000, $300,000 a year, I would question whether replacement ratios over 40% or 50% make any sense. So replacement ratios are still too high.

TABLE 1
REPLACEMENT RATIOS

Annual Income	Individual DI Limits			Combo Group/ Individual Limits	
	1985	1990	1995	1990	1995
$ 40,000	96%	90%	90%	91%	89%
80,000	91	84	84	93	86
120,000	80	75	75	96	90
240,000	67	63	63	101	95
360,000	57	56	56	98	95

In our earlier presentation there was a comment about the increase in life spans. Mortality ratios are going to decline. What does that tell you about morbidity rates in general over the next 10 or 20 years? What does that suggest about the pricing assumptions that you need to make for a noncancellable contract or for a GR contract when you may or may not be able to get the rate relief when you need it?

The problems that have been facing the industry have not been solved. Replacement ratios are too high and products are much, much too expensive. I do not believe that noncancellable is viable in its present form. I do not believe that GR is viable in its present form. There are many contractual provisions that companies have added in recent years that make sense. Putting long-term-care options into a disability product is a significant step in the right direction. So there has been some movement in the right direction. I believe that disappointing sales and profits will continue. In many cases, new in-force business is unprofitable and will not become profitable over a period of time. New business is probably

profitable, but I would suggest that new business is not as profitable as most companies would like it to be.

Both Dan and Dave talked about the significant need for disability protection. That is a point I would have you come away from this meeting with. There is an enormous need for disability insurance. We really have not talked about the need for DI, the probability of a long-term disability versus that of death. The fact is that maybe four times more mortgages are foreclosed because of disability than because the mortgagor passed away. There are large, unserved markets. I have seen some statistics that UNUM has put together that show much less than 20% of people are even approached to buy disability insurance.

If you look at the trends in the work place, individuals are increasingly being asked to take responsibility for their own financial security. There is more outsourcing of work, more use of temporary workers, dual incomes, people working at home, much more frequent job changes. In that kind of an environment it is very difficult for an individual to look to an employer to provide for his or her own financial security. So the need for disability protection is there, and the best way for an individual to get that protection is through the purchase of an individual disability product. It may be that those products can best be distributed through distribution systems that are different from what you see today. In addition to present distribution systems, there are opportunities for alternative distribution.

And, finally, radically different product designs should be considered. If you were to start with a clean slate, forget about your antiquated computer systems, forget about your market research surveys, which, in many cases, are nothing more than surveys of your producers. Many companies that would call themselves market oriented are really more producer driven than market driven. What they are providing or what their producers tell them they want to sell is essentially what they sold yesterday. And when you ask them what they need, they will say that they need to compete with the product that they lost to in competition the day before yesterday. You really need to look out to the end consumer. Here is one area that offers an enormous advantage for disability companies because, other than a few select markets, physicians being the best example, most end consumers really do believe they need some form of disability protection, but they do not have a clue what that means. So, a company could design a product and a marketing and distribution program along with that product that would effectively respond to the perceived needs of the end consumer.

There are some very, very interesting and creative product designs in other countries, the U.K. in particular. The U.K. does not have the same regulatory environment that we have. We can take pieces of the U.K. products and apply

them in the U.S., because some of the concepts would apply. There is a lot that companies can learn by looking at other lines of business as well as at other countries. The product needs to adjust to the changing needs of the policyholders, and that means changing income needs, changing employment circumstances, better risk protection, the ability of a company to change price and perhaps share some of the risk with a policyholder.

Most of you are familiar with variable life, or universal life, or adjustable whole life policies where the insurance company can change its mortality charges. Why can't you have a disability product that works the same way? Why do you have to make a long-term 20-, or 30-, or 40-year bet on morbidity? I would much prefer to make that bet on life insurance, because I know the trend in mortality. I do not know what the trend in morbidity is going to be.

There is a chance that morbidity costs are going to increase. I would much rather use the capital, not just lower agents' commissions. If you make the product easier to sell and easier to underwrite, then you could lower the commission and the agent would still sell it. But it would be hard to do that and get away with it in the current environment. We need products that have a better capital flow, where you do not see the capital outflows in the early years, or products that might require less risk-based capital as well. Implied in all that are products that are easier to buy from any consumer's perspective; easier to distribute, whether you use intermediaries or not; and much easier to underwrite.

Alignment is the key to achieve any proposed changes. Alignment means having the interest of the company, the interest of the distributor (if you use a producer), and the interest of the end consumer (the policyholder) all aligned. Everybody has to win or nobody is going to win. It even goes beyond that within a company. It means getting your actuaries on the same wavelength as your underwriters, claim examiners, salespeople, and marketing people. It means designing your product for the specific market in which you want to sell it so the contract provisions will work with that product. It means having underwriting rules and procedures that are consistent with the market needs as well. That is what alignment is. It is extremely important that your critical functions be aligned if you are going to be successful in the disability business. It is much easier to say that than it is to do it. And I am not sure that there is anybody who is really as well aligned as they need to be. To me that is another critical element if you are going to be successful in the business.

From the Floor: Have you seen any numbers on unit sales of GR policies? I am hearing anecdotally that more and more are getting out there, but I have not seen them.

Mr. Koopersmith: I have not seen any statistics on guaranteed renewable sales recently, meaning 1996. The most recent I have seen are 1994 or 1995, and I think the jury was still out based upon that evidence.

Mr. Skwire: We have done some research just based on the numbers right out of the Life Insurance Marketing and Research Association (LIMRA) studies. I was looking at premium rather than numbers of policies, but it showed that if you look over the last five or six years, you have mostly an 8–10% annual decline in the noncancellable premium. Also, it showed about an 8–10% annual increase in the GR premium. And I would expect that we will see the GR start to pick up even more rapidly in the next few years.

Mr. Mark S. Seliber: Before I get to my own question, I can also partially answer this last one. I received a preliminary copy of the LIMRA Sales and In-force Study for 1996. In 1996, noncancellable sales by premium were down 21% and GR was up 20%. That continues your pattern, Dan, but at a higher level and, as you said, that would be expected. Of course, the noncancellable numbers are much larger ones, so if you have weighted them it is probably still down 15% or 16%.

My question is on alignment. You started to talk about that, Mike. I would like to have any of you comment on the main ways to achieve alignment. Would that be more level commissions and, also, to have the compensation to brokers and general agents and managers tie to the persistency and morbidity experience on the business that they are selling?

Mr. Skwire: I guess the question is, In what sort of ways do we try to align producer interests with company interests? You touched on many of the key ones. Part of it is making sure that you understand where the producer's money comes from. It comes from different sources. You need to give the producers products that they can sell. You need to give producers the support that they need, to make that sale. You need to give them the technology that they need and, of course, you have to give them the specific payment, the commission. There has been a lot of complexity that has been added to those commission structures trying to build in incentives, especially around persistency and profitability. Profitability is a difficult one when you are dealing at a producer level, because it is so difficult to get any kind of credible data. It is hard sometimes even looking at large segments, at occupations, and when you get down to the individual producer that can be a real challenge.

Mr. Simbro: At the producer level I would echo the same concerns. But certainly at the management level, if you have some type of distribution system where someone is overseeing a large number of producers, there are opportunities to dig

into variances in the results between different managers. You will find it very valuable to monitor that as closely as possible and create whatever incentives you think are appropriate to try to reduce some of that variability.

Mr. Skwire: I should mention one other thing, which is a possible area to focus on, the whole customer service function. You can really add value for your producer by improving customer service, by making it easier for producers to do business with you. That is an opportunity for them to make more money if you can turn business around more quickly and devote more of the producer's time to selling and less to doing some of the mundane enrollment tasks.

Mr. Koopersmith: Let me also add a couple of additional comments about producer commissions or producer compensation. You almost have to segment producers the same way you segment markets to really understand what drives them. The better producers really are interested in what is best for the clients. They are also very much interested in what they can do to make more money, and they have opportunity costs. They have to decide that it is in their best interest to sell the disability product as opposed to selling something else.

It has been my experience that at the very bottom of the list there are a handful of producers who are never going to do what the company wants them to do. They are the casual producer, and they sell maybe one or two disability policies a year. I do not think it makes much difference what you pay those people. They are going to sell the product. It may not even be a product you want, which is an underwriting or risk management issue. But I think you can really chop these commissions. Unfortunately, if you look at the distribution of sales for most companies, there is a larger percentage of business sold from the casual producer than most companies like. That is an area where you do not have to pay top dollar. You should almost target yourself to pay less than the competitors. Send that person some place else, if you can, and use that money either to improve your margins or to spend on some other producers.

Then there is a much larger group of producers who have the potential to give you quality business. Those are the producers that you want to do whatever you can to align their interests with yours. You can do that both through compensation and noncompensation means. You can use persistency bonuses. Persistency is not just a good measure of quality. In my experience, it is a reasonably good predictor of morbidity as well. So if you have somebody with consistently good persistency experience, you are likely to see somewhat better morbidity experience as well. It is very difficult to use morbidity at the producer level. However, you can have some morbidity incentives at the manager level.

The other thing is to try to build whatever kind of a relationship you can with the producer so that it is easier for him or her to sell your product than somebody else's. You can use sales support, proposal systems, things like that. Anything that you can do to tie the distributor to your company is just one way to make it more difficult for that person to leave and sell products for somebody else.

Mr. Paul D. Hitchcox: I just wanted to ask you about the encroachment of group products into the individual market, that is, voluntary products out there, mini-plan products, that go down to two life employers. It is much easier to enroll in a voluntary plan with minimal underwriting. What are your thoughts as far as what that is going to do to the individual product going forward?

Mr. Skwire: I think it is a really interesting question. They are getting closer together. There are some cases where it is difficult to tell which platform you are on. You know mechanically some of the biggest differences are just on the regulatory platform you happen to file it under. Term products have advantages. Employers are not really interested in prefunding morbidity charges for people who might be taking off down the road.

But term products do have some challenges, too. They have some challenges from the expense side. It is going to take a little longer to recover some of your up-front investment in putting the business on the books. And they have some challenges from the persistency side, too. As the premiums build up you are going to lose some lives who are unable or unwilling to pay that premium. That has some risk consequences as well as just how much premium they are getting in the door. So there are pluses and minuses both ways. I think that both product models have a place in the market.

Mr. Simbro: One comment I wanted to add was a bit of a concern I have for the potential for individuals to have individual coverage first and then add group afterwards. It may be somewhat of a surprise to some on the group side if they were to study the replacement ratios that the clients effectively have.

Mr. Koopersmith: In today's environment, group products in most cases provide a much better value than individual products. It is not much more complicated than that. So given the nature of what you are trying to accomplish, which is to insure people if they are sick or hurt and cannot work, you can get much more coverage at much better value with a group product than you can with an individual product. Having said that, given the current environment in the work place, the trends, employers are increasingly looking to find ways to keep their employee benefit costs in line. This means that they may make benefits available to their employees, but not necessarily be willing to pay for them. So as an employee, I would not be

comfortable relying on my employer to take care of my needs through group insurance, if there were a better product alternative out there. There is no question in my mind that individual disability can play a major role. But, again, considering the current environment, the kind of products that you can buy if you want to buy an individual product, and considering their costs, I think most people are probably well served to hold on to the group coverage. It is a better value.

Mr. David G. Fitzpatrick: I have a question for Mr. Koopersmith on your replacement ratio chart. I am assuming that is a pretax replacement ratio. I was just curious if you thought the ratios were much different after taxes.

Mr. Koopersmith: I believe that was an after-tax chart, which makes it even more scary. One of the things (and this relates both to your question and the previous question about group and individual coverage) that you see from many companies is this multilife marketing, where you might go into an employer situation or a professional corporation, law firm, or physician group and what you are selling are a number of individual products in a multilife environment. Often there are discounted premium and lower commissions as well, the theory being that there are some economies of scale in a multilife environment. In some cases, those products are being bought based upon an assumption that the employer is paying the premium, so the benefits become taxable. So you give them a higher replacement ratio under the assumption that the benefits are taxable, and then what happens is you switch and the benefits are no longer taxable. So it takes the overinsurance situation and it just exacerbates it even further.

Ms. Kim H. Tillmann: This is a question again about the whole overinsurance issue. I have heard different people speak about two things that seem to be trying to address this problem. One is the high replacement ratios and the other is making the benefits more hooked to the actual earnings. I was wondering what the panelists thought of which one is going to happen first, and what direction that may take?

Mr. Skwire: We have begun by focusing on the replacement ratios. I think that is a little easier change. I was actually kind of surprised by the numbers that Mike had up there. It is difficult to know with after tax and before tax, and every company has different ways of reporting results. Those look very high to me. I think the basic formula is something like 50% of your income up to the first $150,000 and 30% of the marginal amount thereafter. That is probably a little bit below market in some cases. I think you still have other companies that are writing more than that. I was not aware that many companies were writing much above 80% though, in any case.

The issue of benefits more linked to income is an interesting one. While that is very easily done within the group regulatory model, there are some legal kinds of complications in doing that with the individual platform. Some of those issues are going to have to get worked through a little bit. If the amount of your coverage is going up and down, if the amount of benefit you can get goes up and down each year, sometimes the state departments are not too crazy about that. They need some more rules on what is going to happen with the premium, or often they are concerned about whether you are paying for a benefit that you could not get. So we have got to solve some of those issues, I think, before we can move ahead with that product design.

Mr. Simbro: We have done some of the things I was alluding to in my presentation earlier. We have made some changes within the medical market in terms of participation limits. We were discussing the issue of taxable benefits and the sudden switch that occurs from the way it is purchased at issue and then who is responsible for the premium payment at the time of claim. We have eliminated the ability for extra coverage because the benefit is taxable in the medical market, and we found some rather disturbing trends there.