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Session 3PD
Hot Topics in Group Long-Term Disability Income

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Summary: This session starts with a short presentation of current financial results and experience trends for the group long-term disability industry. Following that, panelists discuss issues of timely relevance to group LTD actuaries. Topics include new product trends, the impact of integrated disability initiatives, and additional issues of current interest.

Mr. Paul D. Hitchcox: I'd like to start off by introducing our panelists. Dave Fitzpatrick is assistant vice president and associate group actuary with Standard Insurance Co. and Dan Skwire is an actuary with Milliman & Robertson.

I'd like to start by going over some of the goals of the session. I want to take you through some of the new product trends. There are a lot of hot topics out there, and we're going to hit some of them. We're just going to touch upon the financial results.

I'm going to start off with late-breaking news. The association business is going to be one of the hotter items going forward, and we are going to talk about the challenges and opportunities.

Mr. Daniel D. Skwire: Big news from the State of Oregon. Following in the footsteps of UNUM, Equitable, Guarantee Life, All-America Financial, and Mutual Life Insurance Co. of New York, Standard Insurance Co. voted recently to develop a plan to demutualize and become a publicly traded company. The company says that the demutualization process will take 18–24 months to complete, and,

Note: The charts referred to in the text can be found at the end of the manuscript.

according to *The Wall Street Journal*, policyholders could receive more than $500 million primarily in the form of stock.

Mr. David G. Fitzpatrick: Traveler's Property/Casualty Co. and Metropolitan Life Insurance Co. announced that they will jointly manage worker's compensation and disability claims for a select group of employers as part of a pilot program. Five administrative facilities will be staffed by a combination of Travelers and MetLife personnel. The first, in Hartford, is already up and running. The other four are expected to be operational between July 1 and Dec. 1.

Mr. Hitchcox: Prudential Insurance Co. takes steps to convert to stock ownership. An estimated 11 million life insurance and annuity owners would become stockholders with net worth of about $20 billion. No stock offering is planned, but the cost of demutualization is expected to be around $300 million.

Mr. Skwire: MetLife announced on March 6 that it expects to convert to some form of stock ownership within the next several years. MetLife's chairman said in a statement that the company plans "to explore ways to improve our access to capital to ensure that we remain competitive in today's challenging financial services marketplace."

Mr. Hitchcox: John Hancock is set to sell shares to tap the equity market. The 13th largest insurer with four million policyholders, it expects the cost of demutualization to be approximately $100 hundred million. I'd like to turn it over to Dave with the sports.

Mr. Skwire: We've received a special report from the disability Reinsurance Management Service (RMS) LTD Profit & Market Survey. The net gain after taxes last year rose from 1.2–3.1%. The number of insurers posting losses dropped from eight to six.

Mr. Hitchcox: It is possible to do the weather with LTD. I believe very firmly that some economic trends have a major impact on LTD, things like the unemployment rate being a driver of incidence. If people are becoming out of work, there's certainly good reason to believe that more people are also becoming disabled. And employment growth is a great source of return-to-work effort, claim recovery potential, and consumer confidence. When you're confident about what you're doing and living day to day, you're going to be less likely to file.

Here's what the LTD risk has looked like from 1978 to 1998 for the last 20 years. We started off with a high-pressure system moving along the East Coast. As we went into 1979, scattered thunderstorms were brewing in the Central and Midwest

region. By 1980, they were intensifying in the Central region and spreading throughout the country. 1982, we saw increasing pressure on LTD as unemployment rose and employment growth became constrained. There were Major storms in the plains and Midwest. High pressure continued, but around 1984 something started to break with high tech and computers. Along the Eastern Seaboard, you had Wang coming alive as a major force. Therefore, sunnier skies were forecast for the Northeast, as high-tech and computer-related industries drove down unemployment and drove up employment. In 1985, we saw improving skies throughout the U.S. In 1986, Texas and the South remain under darker skies because of oil-related industries. In 1987, the Northeast continued leading the economic recovery with clearer weather.

Unfortunately, in 1990, we had a breakout of doctors and lawyers with more scattered thunderstorms, particularly in California and New York. Thunderstorms continued, especially in California. But there was hope because of continuing improvement in the Midwest. High pressure continued along the Central region. At this point the economy really did start to improve as sunny skies appear across the United States.

When you think of how dark it was in the early 1980s, it's pretty remarkable to see just what type of improvement we're seeing in terms of risk index in the 1990s, and it continues to improve.

Mr. Fitzpatrick: In the past couple of years, it's been difficult to attend an industry meeting on disability without hearing about new developments in integrated short-term disability (STD) and LTD, acquisition pricing, field underwriting or underwriter discounts, the latest angle on managed disability, limited benefit durations on self-reported disabilities, voluntary products, industry updates on high-tech and blue-collar risk, 24-hour coverage including worker's comp, and the latest advancements in technology.

I'd like to take a different approach and spend a few minutes looking forward, more specifically at where group disability might be 10 years from now. As actuaries, we're often accused of spending too much time on the past and not enough on the future. With the changes going on in the disability market currently, looking ahead is becoming more important than ever.

With the help of some of my colleagues at Standard, we took a look at the future and attempted to predict what group disability will look like in the year 2008. The areas we looked at included key plan features, new trends in pricing, underwriting considerations, how the product will be sold, changes in policy administration and services, integrated disability, voluntary products, contract provisions to reduce high

replacement ratios, new ideas in managing disability, and changes in the workplace, profits, the legal and regulatory environment, and valuation.

Turning our attention to plan design, successful carriers will continue to focus on replacement ratios that encourage claimants to return to work. Income replacement will target 80% of take-home pay or less. STD/LTD plans as two contracts will be replaced by one, with benefits starting from day four. Changes in definition from own occupation to any occupation will occur more frequently at 12 months versus the traditional 24 months. The move to more restrictive activities of daily living (ADLs) will continue, with the inability to perform at least two ADLs becoming a popular option. Disability due to mental disorders, drug and alcohol use, and self-reported disabilities payable until age 65 will be the standard, with an appropriate increase in price. And many policies will have a rider that pays an additional benefit in the event of a serious illness such as a heart attack, stroke, or the inability to perform at least two ADLs to cover medical and rehabilitation expenses.

Coordination with income replacement in long-term-care coverage will provide employees with lifetime coverage. With continued pressure on worker's compensation, individual insurance, social security, and other group insurance, benefits will be fully coordinated through a coordination of benefits provision. I'll discuss this more later. The maximum benefit period will dovetail with the employer's earliest available retirement date, such as age 60, and many plans will have an option to continue employee contributions to a 401(k) plan or similar plan by directing a portion of the disability benefit.

Prices will continue to be extremely hot and will still be the primary reason an employer chooses a carrier. There will be less acquisition pricing as carriers learn the hard lesson at the end of the century that automatic renewal increases signal an employer to shop for rate stability and, subsequently, lead to increased policy lapse rates and reduced earnings. The new North American Industry Classification system will have been completely implemented and used by all carriers for industry/occupation rating. With 10 years of competitive pricing and lower profits compared to the prior decade, fallout among carriers will continue through mergers and acquisitions. And there will be an increase in competition from other financial services, including mutual funds.

With respect to underwriting, improvements in technology and higher customer expectations will drive contract and certificate delivery to within one week from the coverage effective date. Optional performance guarantees will be routine down to 100 life groups. And, with access to superior financial information, there will be improved ability to predict and price for layoffs or mergers. Sometimes when we look into the future we see more of what we'd like to see as opposed to what we

will see. In the year 2008, the actuary's rate and the underwriter's rate will be one in the same. This is probably one of the things I hope to see because it's one of the key problems with financial results. I think it's the actuary's responsibility to identify, understand, and fix the problem. One thing is sure: underwriting cycle times will be faster.

With continued pressure on prices and growing involvement with worker's compensation, which is already written directly in some cases, small group coverage will be available over the Internet. I recently read in the April 13 issue of the *National Underwriter* that Provident American Corp. will provide quotes and accept applications for small group health, dental, vision care, and long-term-care insurance. According to the article, going direct without an agent allows online purchasers to receive a 10% discount. The consumer still has an option to use an agent and forego the discount.

The mid-size market groups between 100 and 999 lives will be available over the Internet as an option. Large groups will continued to be handled by brokers and consultants due to their inherent complexity. Another key change will be major brokers targeting two to three carriers as the preferred carriers to do business with.

Monthly billing and member maintenance will be handled electronically over the Extranet as electronic fund transfers linked to the employer's payroll. Commissions will be by direct deposit at the time of premium payment. Medical information from doctors will be received electronically, enabling benefit analysts and medical underwriters to make quicker decisions. Employers will be outsourcing more services, such as payroll, family leave, Americans with Disabilities Act, and sick leave administration.

After many years of talk on a consolidated STD/LTD product, carriers will be delivering the real thing. There will be one contract and one rate. Benefits the customers are accustomed to receiving will be available. The payment mode will be the same as the employer's weekly, bi-weekly, or bi-monthly payroll. Worker's compensation will be included as an option to the consolidated product.

Voluntary products will continue to grow as employers look for ways to control employee benefit costs or add new benefits. To keep costs reasonable, carriers will offer plan designs and underwriting requirements more in line with traditional contributory plans. Voluntary plans, including contributory plans, will approach 50% of the market, and experience will show an increase in claim costs due to higher after-tax replacement ratios. The current primary barrier of fast and friendly enrollment will be achieved through Internet enrollment and easily understood plan options.

Medical carriers learned the hard lesson 20 years ago about what happens when insureds lose financial interest in medical expenses. All income replacement benefits available to an employee including worker's compensation, social security, individual disability income, and other group benefits will be carefully coordinated to limit total income replacement from all sources. Group disability, individual disability, and worker's compensation benefits will be determined on a pro rata basis. In the case of multiple group and individual policies, the latest coverage effective date will be primary. Finally, there will be a central clearinghouse similar to the Medical Information Bureau. The clearinghouse will allow carriers to check for other insurance and will facilitate notification of retroactive awards.

Successful carriers will continue to find new ways to improve claim management, with an emphasis on fairness and early return to work. The focus will be returning the claimant to work with the same employer within six months or to another employer within 12 months, and there will be greater incentives to employers who encourage reemployment of disabled workers. Longer duration claims will receive more attention on nonlife-threatening disabilities.

At my company the top seven causes of disability account for nearly 75% of LTD claim costs are:

- Back/neck (20%)
- Heart/circulatory (18%)
- Joints (13%)
- Mental disorder (9%)
- Cancer (7%)
- Physical nervous disorders (7%)
- All other (26%)

During the next 10 years, while it is reasonable to expect these seven causes to continue to dominate the claim cost dollar, there are certain to be new disabilities and better diagnosis of all disabilities. It is interesting to note that a change in the top three could have a material impact on disability costs. As an example, Acquired Immune Deficiency Syndrome (AIDS) claims have exhibited a remarkable change during the past several years. Since 1995, Standard's AIDS claim terminations due to death have decreased by 70%. All of us have read about AIDS mortality improvement in the press. What I find of almost equal importance is that we are now seeing a change in return to work, and I expect this trend to continue.

I read recently that about 7% of employees are working at home. In 10 years, this could easily increase to one-third of all workers. It'll require some creative claim management. While it will offer more opportunities for claimants to return to work

sooner, it's also susceptible to more fraud. The rate at which working at home will grow is dependent on employer confidence that productivity will increase. I see the rate lagging a few years behind the growth in the number of casual days.

Pressure on prices has never been greater. The recent John Hewitt and Associates Profitability Study showed a drop in profits in 1997 versus 1996. Although this year's disability RMS Profit Survey showed a slight decrease in stat next gain after-tax income, 35% of participating companies showed an operating loss. Because of multiple-year rate guarantees and rate approval requirements, I don't expect this to change for the next few years. Successful carriers are targeting 12–15% return on equity. As carriers fail to achieve this, there will be fallout, with both winners and losers subject to merger and acquisitions.

On the legal and regulatory front, we will continue to see state regulation. Litigation costs will continue to climb, and consumer and market conduct issues will receive much attention. The 1987 Commissioner's Group Disability Table will be replaced by a new table with the single-premium immediate annuity interest rate as the valuation basis, and by 2008 all 50 states will have adopted it. The new table will allow company adjustments when it can be demonstrated that their own experience warrants them.

I'll close with a challenge to disability actuaries to stay involved with product development as we go through the changes over the next 10 years. In addition to the usual pricing, valuation, and financial reporting requirements, it'll be important that we stay involved in changes in administration, claim services, and underwriting.

Mr. Skwire: With the challenge of doing something out of the ordinary I decided to talk today about the complex but alluring world of association disability. In many ways, association business is a hybrid of group and individual disability business. Unfortunately, that means it is twice as hard as those other two approaches. Companies that have attempted to treat association business like group disability have often run into problems on the risk side of the business. Frequently, the underwriting has been too loose, both medical and financial underwriting, and there's been a little too much reliance on case-level rating, especially with smaller size cases.

Companies that have approached the association market as if it were an individual disability market also have run into problems by trying to introduce products that are simply too complicated and too expensive for the association market. And they've also been slow to recognize the dynamics in association cases, which are that they can move very quickly and all at once. Individual companies are used to

looking at individual lives making decisions on whether to stay, lapse, or seek other coverage. Association business can move as quickly as group business, with millions of dollars coming and going in a matter of a couple of days.

The association channel is very specialized and demands special attention. Let's look at some of the features that makes it so distinct from either individual or group insurance. I don't remember a great deal from my days in Economics 101. I mostly remember a lot of x-shaped graphs that kept shifting back and forth for reasons I never managed to understand. But I do remember one lesson: that the behavior of individuals is very frequently motivated by money. Therefore, in looking at this channel, it might be interesting to try to understand the motivations of the different links in the association disability food chain by considering how people get paid in this arrangement.

The first link is the insureds. They are paid by collecting benefits if they make a disability claim, which means that their interest lies primarily in the features of the product and in the premium rates for these products. Not too long ago, the typical buyers of association disability business were self-employed professionals, members of professional associations, and individuals who were not very sophisticated financial consumers. Usually the reason they were purchasing insurance through associations was because they didn't have close relationships with insurance agents, with financial planners, and so on, and they found some real appeal in the simplicity of the direct mail approach for the association business. But that's changed quite dramatically in recent years, and the newer buyers of association disability business have higher incomes and are much more sophisticated financial purchasers.

More and more often these folks are buying their insurance in layers. They might already have group disability from one company and individual disability from another company. Now they're weaving association disability into the mix. This is a very important shift in this marketplace, and it's one that a lot of companies, especially group disability specialists, have been a little slow to recognize. It's very important in a market that's going through these dynamics to ensure in your financial underwriting that you're getting the right types of information about other coverages that people have in force—and that you're getting the right types of documentation for income as financial and tax situations get more and more complicated.

The next link in the association food chain is the association. Associations are paid by collecting dues from their members, so their primary object is to provide a good set of benefits that encourage people to join and to try to keep operating in a fairly

stable environment so that the members are happy with their coverage and will continue paying their dues.

The people at the association who make decisions on insurance plans are not insurance experts. By profession they're probably doctors, lawyers, or some other type of professional, and it's generally a volunteer position for them. They typically have an insurance committee that makes some of these decisions, but that's not where they specialize. As a result, they will contract with a third-party administrator (TPA) to perform the insurance functions and to advise them on all aspects of their insurance plans.

The TPA is probably the crucial link in the food chain. The TPA is paid as a broker or agent on commissions paid by the insurance company. Commissions on association plans, like the rest of the plan, is a combination of an individual and a group commission scale. It's a level commission, as you're accustomed to seeing in group disability, but it's also a fairly high commission as you see in individual. Typical levels might range from 15–20% of premium, and some go even higher than that, depending on the specific functions the TPA is performing. With that level of commission and with the level pattern of the commission, the motivation of the TPA is to keep things running smoothly. Many administrators are in maintenance mode; they want to keep the case happy so that those nice renewal commissions continue rolling in.

The specific functions performed by the administrator include such things as negotiating the endorsements between the association and the insurance carrier. These are usually exclusive endorsements, which is to say that an association will work only with one TPA. Likewise, an insurance company will need to provide an exclusive product offering to that association and administrator. The company will typically agree not to let its own brokers or agents try to sell other products from the company to that same association through the back door. Exclusive endorsements are a very important feature of this channel.

In day-to-day business, the administrator will focus on marketing the plan, generally through direct mail, to the Association members to try to generate new enrollees. In almost every case, TPAs will perform billing and premium collection services, netting out their commissions, and then remitting the net premium on to the insurance company. In many arrangements, TPAs will also be responsible for performing the individual medical and financial underwriting on applicants and for performing claims management and adjudication. Sometimes you'll get into higher levels of compensation if these services are being provided.

That's a broad range of services, but the central function of the administrator is to provide advice to the association on what to do with these plans and to keep the lines of communication open between all the other members of the food chain: the insurance carrier, the association members, and the association's board of directors. It's a fairly big job. Individual companies have frequently been a little bit slow to realize the extent of the control that TPAs have over a given case and to understand why they have such a vested interest in not doing anything to rock the boat when it comes to rate increases and changes to the plan.

The final link in the food chain are the insurance carriers, which are paid through the bottom line. They're making profits on the business, which means their primary concern is to balance sales, profits, individual persistency, and case-level persistency, and that can be a very complicated process. Carrier need to have a very heavy level of involvement in product design, in coming up with the underwriting rules, in developing the rate schedules, and in managing the retention formulas if the case is experience rated. It's a very important role that gets pressure from a lot of different areas and a lot of different constituencies.

It's a little difficult to generalize about the plan design provisions in the association disability marketplace because the plans tend to be very customized and varied. But the intention of the various plans is to meet the desires of the insureds who will be purchasing this coverage, and that's often done through the carrier's own perception of what is required in the marketplace. In most cases, you will find that association disability products have a group feel to them. They are usually written with attained age premiums, a five-year type of age band, and filed on the group regulatory platform, a conditionally renewable contract where the conditions include such things as the insured continuing to be a member of the association, continuing to be actively at work, and the association continuing that exclusive sponsorship of the insurance company's plan so that they know that all the business from that channel will be coming into them.

Because association disability buyers were not very sophisticated financial consumers until recently, association disability products of a few years ago were fairly simple products. They didn't have a lot of variety to the definitions. They tended to have fairly short benefit periods, inexpensive rates, and, in many cases, low maximums for the plan. But as the buyers became more sophisticated and wealthy, the products started to change into more of an individual disability product. They became richer and pricier. This resulted in an unfortunate situation. I think that this market shift has created an identity crisis for association disability writers, and resulted in some very confused responses by companies who aren't quite sure what the marketplace looks like anymore.

As the new buyers began to find other types of coverage, group through their employer or individual through their insurance agent, many companies started to introduce richer association disability products. Unfortunately, at the same time, they tended to retain some of the simpler group features including some of the group underwriting techniques that made the product easy to offer but that resulted in some difficult risk problems. The result has been challenges for both profits and sales. Let's take a look at a few of these problems from the perspective of the TPA as well as the insurance carrier.

The TPA has been kind of getting hit from both sides with marketing problems. There have been marketing problems at the individual level for the reasons I've described. Association specialists have lost business to group disability companies, particularly in the physician market, where physicians are being covered through employers instead of solo practices. And they've also lost business to individual disability because members of associations are seeing complicated coverages and high maximums. It takes a lot of underwriting. You've got to go through all this work to figure out what the contract is all about. You need some financial advice. Why not buy individual coverage for all that work?

At the same time, TPAs have seen some marketing problems at the level of the association itself. TPAs in this business tend to rely very heavily on a couple of cases. It's not like a broker who might have a number of different employer clients. Many TPAs will have only one association for whom they provide benefits, and they will also be providing not just disability insurance but several lines of coverage. Medical malpractice, medical expense, and life insurance is common. That means the TPAs are unwilling to risk their entire block of business and their entire livelihood for the sake of changes to disability contracts. That's one reason there's been a lot of resistance to placing some of the rate increases and product changes that have been necessary in this market.

Of the concerns from the insurance carrier's perspective, one of the primary ones is the fact that the association marketplace is concentrated very heavily on a few specific occupations, namely, the medical, the dental, and the legal professions. These have been pretty challenging professions for disability insurers recently. There have been some sales problems in this marketplace, so the market itself has been trying to fight this sales decline with some very aggressive rating. That has not helped the profitability situation at all.

The result has been a deterioration of the relationships between insurance companies and the administrators. In some cases, you've had too little trust in the TPA from the perspective of the insurance companies, an unwillingness to listen to some of their ideas on how to change things and approaches that might be

necessary to make the changes and yet retain the case. At the same time, there have been many situations where there was too much trust between the insurance company and the TPA and the insurer has chosen to delegate a lot of the risk management functions such as claims and underwriting to the administrator, and that's a difficult situation.

Remember that an administrator is paid on commissions, and that's a tough way to pay the person who's making your underwriting decisions. If they only get paid by accepting a case, that's a little bit difficult and that probably speaks to the need to examine some of the compensation arrangements if there's a need to continue with outsourcing some of these claims and underwriting functions.

Chart 1 is a simple comparison of the rates for an individual disability plan and an association disability plan for a 40-year-old physician. These are actual plans in the marketplace. I tried to pick two that were very similar in their provisions. And, by the way, I think it's better to compare individual disability rates rather a group premium because of the very low levels of participation that you see in associations. Because of the fact that you're doing the medical underwriting, you have an individual type of expense structure, so I think the comparison makes a little more sense.

The association plan is priced in an attained age, five-year age band, and the individual plan is a level premium. It illustrates some of the challenges of the attained age rating structure. To have sufficient appeal at the time of the sale, you have to come in pretty low to sell against the level premium writers. However, when you come in that low, often the present value of your premium isn't going to be high enough. It's hard to make it up at age 50 if you're not collecting it at age 30. It is not unusual to have two different rate schedules for the same benefits and have the association plan collecting about a third less premium on a present value basis over that period. This is part of the reason that some of the profitability problems have existed in this marketplace.

Chart 2 illustrates one of the challenges on the marketing side of this business. This is an illustration of the dollars of commissions that are paid to the administrator on $100,000 of new business. The solid line is a typical individual, high/low disability commission, paying 85% in the first year and grading downward. The dotted line is the association disability scale, which is a level commission. A lapse rate is in this projection, and the association plan also has the banded premium. So, the premium moves around a bit, but stays pretty close to level, even with the lapses factored in.

That illustrates how the administrator's compensation, even on a closed block of business with no new sales, is staying fairly level. The association administrator, then, has much less incentive to seek out new sales than does an individual disability broker or agent who really needs that first-year push. That's certainly a challenge on the marketing side.

I said that the association disability market was both complex and alluring, but I've talked only about the complex side of it. I probably sound a bit pessimistic on this market, but in many ways I'm also optimistic. Association disability has one, big advantage over individual disability and group disability: It has a unique method for reaching uninsured people who may not have other means of purchasing disability insurance. But it's very important to go after this market in the right way. One of the first steps for companies who have blocks of association disability business has to be stabilizing the in-force business, and that's going to be difficult. It means things like getting through the rate actions, getting the right kinds of product changes in place—the underwriting arrangement and also the underwriting rules that are in place—and maybe having a better grip on the medical underwriting rules that are necessary. I don't think it's necessary, except in very severe cases, to try to do everything at one time, but it is necessary to get a start on these steps, work closely with the administrators in this process, and educate them about what's happening in the market and why these changes are necessary. Ultimately, it's the administrators who have to stand up in front of the associations and try to persuade them to endorse this kind of change instead of taking their business somewhere else. So, it's very important for insurers to make allies out of the administrators in this situation.

It's a little more fun to think about going forward and looking at growth instead of fixing the in force, but when you try methods of growth for association disability, it's going to be very important to look beyond the traditional professions—the medical, the legal, and the dental—because it appears that those professions are finding their way into the group market and individual markets and may not be as well-suited for association disability as they were in the past. It will be very important for the association writers to focus on people who cannot find disability insurance elsewhere, that growing part of the population who are working at home, self-employed, working on a temporary basis, or moving from one employer to the other and don't fit into the current disability insurance structures. These are the people that the association disability market used to serve, except that the occupations have changed. So, I think it's going to be important to get back that vision, and it doesn't have to be only professional associations.

The affinity marketplace is also a very interesting one. It can be groups that are linked through an alumni association, hobbies, or almost anything. Once you have

that affinity, the challenge is coming up with the appropriate types of products to market to that group so that you can make a profit. It doesn't have to look like individual disability. It doesn't have to look like group disability. It can be something entirely different to fit that market.

I'm going to close by giving you a couple of marketing leads. My office in Portland is located right next to the public library, and every so often I'll duck over there on my lunch hour. When I was there working on this speech, I saw they had a four-volume directory with about 30,000 pages of association memberships in the United States. It started out with the AAA Foundation for Traffic Safety and moved all the way to the ZZ Top International Fan Club. I found a few associations that do not yet have disability plans. We have the AMM, and I'll be very impressed if anyone has any idea what that one stands for. That's the American Mezzanine Manufacturers, with13 members screaming for disability insurance. It publishes the *Mezzanine Users Guide*. Other opportunities include the ANS, the Armenian Numismatic Association, which has 165 members and publishes the *Armenian Numismatic Quarterly*. Then there is NAMS, the North American Membrane Society, which has 600 members and publishes the *Membrane Quarterly*. They're getting larger and larger. I think our winner for the strangest name I've ever seen for an association, the NA/WPN, which is the North American Department of the Royal Warm Blood Stud Book of the Netherlands. I don't have any idea what that means, but it has 1,100 members and publishes the "North American Department of the Royal Warm Blood Stud Book of the Netherlands" newsletter. Don't everyone run to the phones at once. Thank you very much.

From the Floor: David, my company is quite involved with the integrated disability product right now. How do you handle the different definitions of disability between the worker's compensation product, where it's per-occurrence, versus the group definition per-employee? How do you reconcile that?

Mr. Fitzpatrick: Fortunately I was talking about the future, so we don't have all the answers to that yet.

From the Floor: Well, I need the answers now.

Mr. Fitzpatrick: That's the challenge we have with worker's compensation. In the past, we've looked at benefit payment as trying to figure out who has to pay, and we're all trying to push it onto the other person. The group carriers are trying to push it onto the individual carrier, and the individual carriers are trying to push it onto worker's comp. The transitioning between different definitions of disability will be one of the challenges, but I see that as being one of the necessary things that we have to try to do—work together. If a worker's comp claim is primary, then we

coordinate with that one. The main key to the integration, though, is to cut back on the high-income replacement ratios. We've seen a lot of it at our company, where there's individual coverage on top of the group coverage. Then you get replacement ratios well in excess of 100%, and you know what happens there.

From the Floor: This question is for Dan Skwire. On the new opportunities for the association business, you talked about examining new sales incentives. Could you elaborate on that a little bit? Are you talking about a different type of commission scale that we should be looking at to work with these associations?

Mr. Skwire: Yes. I was thinking along those lines. Ironically, many individual disability companies have been interested in trying to move commissions from the high/low kind of scale to a more level scale for purposes of reducing the capital strain that's associated with that business. I think that issue is less of a concern with association disability because of the attained nature of the rates, where they start out low and go high. That changes your whole equation. I think that the resulting commission pattern with the very flat levels simply is not motivating the administrators to sell new business. It's telling them that they're being compensated as long as the block stays with the carrier, and they don't have anything to worry about. From the company's perspective, if you want to see growth in this business, you need the right incentive. Maybe it's bonuses, or maybe you need to make the curve a little bit steeper in the first year, but it seems that some sort of motivation is required.

From the Floor: So, you're saying try to re-solicit the members? Is that what you're getting at? For those TPAs that are dealing with certain associations, you'd like to see them try and re-solicit more of the members?

Mr. Skwire: Exactly. I want them to increase the participation amount by finding new ways to go after the existing membership.

From the Floor: I have a question about simplicity. I heard about a push in Minnesota, where one of the people running for governor wants to make it mandatory for insurance carriers to say, in very clear, simple language on the front of all the contracts, exactly what is and isn't covered. Lately, the push has been to make things more complicated by adding a lot more features. Do you envision a possible push in the other direction to make things simpler?

Mr. Fitzpatrick: I'll take a crack at the answer before I turn it over to Dan for the in-depth answer. That's a problem that's occurred with solicitation of voluntary products, and it's complicated. We've tried some enrollment teams and other things, and part of what breaks down on the enrollment is you don't have a lot of

time to explain the benefits. I do think that making the contract language simpler for people to understand is going to be key. Now, when you get in a car wreck, the first thing you do is look at your policy and try to figure out how the insurance company is going to get out of paying the claim. We have to work on that one so people understand exactly what they're going to get, what we're going to deduct, and what isn't covered.

Mr. Skwire: I think you raised an excellent point. Many companies have begun to explore simpler types of product structure and product design. The key is to match up the complexity level of the product with the purchaser of the product and the way in which it's sold. When someone is sitting down with his or her own insurance agent at a leisurely pace, comparing products from a few different companies, and getting excellent advice, I think it's fine to have a very complicated product because you can offer some interesting benefits that way. When you're trying to sell through direct mail or over the Internet, then I think it's unrealistic to have a product that is so complicated that it can't be understood without a couple days of tearing through the contract language. Some of these contracts are tough to understand even by a group of specialists during their own product development discussions.

Mr. Hitchcox: I'd throw it out this way, too. If you go back a decade, you had $35,000 maximums, long-term income protection, and all the riders that got some of us in trouble. The law of large numbers that we all love and appreciate has been the movement within the industry. In the last two years, we've seen things like self-reported provisions, what seem to be more complicated pre-existing provisions, and prudent person pre-existing provisions. It'll be an interesting debate whether or not that is considered simplicity, because you're trying to nail down and pay the right claims. Or will it be considered complexity, because you're adding more and more lines to make sure that the right claims are going to be paid? I'd like to think that those provisions are in there to simplify and streamline the plan to make sure that the right claim is being paid.

Mr. John W. Hadley: I wanted to add to Dan's answer on the association product line. I was associated with a leading association carrier for 13 years, and one of the major issues that we faced was that the success of our line had been built around a key group of TPAs who were very successful, but, as Dan said, the compensation that they were getting on the renewals of those cases had gotten to the point where they basically retired. They looked at the blocks, and they had no incentive to continue to produce a lot of new business in many cases. They had made their fortunes. So, there has to be a mechanism to ensure that they bring in additional new business over time. Otherwise, they fall into that trap of having so much

compensation coming in on a renewal basis guaranteed that they just don't care anymore about getting new insureds and re-soliciting.

I don't think the answer is adding additional early-year compensation because it's already a fairly expensive compensation package to manage. I think it should be handled more at the back end in terms of what they have to do to qualify for continued investing the business. One of the pressures is that, when you bring completely new TPAs into the market, they are looking for more of an individual-type compensation scale to fund their start-up costs. There needs to be some balancing around that, but you want it to be a fairly temporary arrangement.

James G. Brone: I have a question about voluntary products. How do you do underwriting on voluntary products?

Mr. Fitzpatrick: I can speak for my company, and we use the pre-existing as our main tool for underwriting. We don't do any individual underwriting on our voluntary. We have a guaranteed issue limit. Above that, we'd have underwriting.

Mr. Skwire: It depends in large part on the structure of the specific voluntary plan, the level of participation you expect to get, and the level of support from the employer. The higher the level of participation, the better. If you have an employer actively pushing the plan, and a design that's going to be pretty uniform for all the insurers, this would lead you to perform a little less intensive underwriting. If the association is a super voluntary plan, where individuals are making a lot of personal decisions, that's the extreme case where you would need a very high level of individual underwriting.

Mr. Hitchcox: When you get to voluntary products, one of the things that happens is that, because it's 100% employee pay, there's generally a thought that the employer is out of the picture. Therefore, we'll try to think in terms of underwriting the employees in terms of pre-existing conditions and things like that. But it's still equally important to underwrite the employer. Some of the failings that have taken place in the past with the voluntary products happened because everything seemed to be set up, you have your best enrollment teams on the case, and the employer says it can't afford to allow you access to the employees. One example is in hospitals, where they have 24-hour shifts, and you have to set up enrollment meetings to hit all three shifts. Having employees available and non-available sometimes can ruin your participation, regardless of how well you've tried to underwrite the employee. So, even if the employer is not funding the voluntary product, it's equally important to make sure you have an employer who's interested in the game and interested in providing the access to the employees. Employers have to understand that they will have to sacrifice a little bit of the employees' time

to have a fairly well-underwritten product, both from the employees' standpoint and the employer's standpoint.

From the Floor: I have a question about your predictions. What perspective was put into this potential converting from mutual to stock of the several companies that you noted? Why not the reverse? Why not remain stock and monetize their stockable assets?

Mr. Hitchcox: We were trying to report on what has been in the news lately. The trend is to gain access to the markets, but could you try that question again?

From the Floor: I came in a bit late, so I took your news reports as being a bit predictive in nature, and maybe I misunderstood it.

Mr. Hitchcox: The mutualizations we were talking about have all been in the news within the last 12 months.

From the Floor: You were talking about the conversion from mutual to stock, but it looked to me to be predictive as well in that this was something that was going to be a continuing trend.

Mr. Hitchcox: It appears to be. The reason I put in that quote from the MetLife chairman is to show that everybody is looking to it as a form of getting access to the capital markets. I think it's increasingly tough for the mutual companies to stand on the sidelines and not think in terms of growth and expansion. It's very interesting that Prudential, as big as it is, is going to consider the change to a stock company and yet not issue stock per se. It will take different forms. And when we're talking about stock holding companies, not the complete conversion to a full stock company. But, with Travelers and Citibank and all the acquisitions and mergers taking place, everybody's going to be looking for that source of capital.

From the Floor: Right, and that's what I see as a trend as well. It would seem like a lot of the advantages of staying a mutual are still there, and perhaps that's what some of these companies are really attempting to do by owning stock without really going public. But what I think also has some possibilities, and I'd be interested in your perspective, is for those companies that choose to stay largely mutual but take some of their assets and convert them into stock assets and retain essentially the underlying control of those. Is that something that's underlying your prediction? In other words, they take that stock asset to the market and generate the capital without really losing control of the asset.

Mr. Hitchcox: Right, and I do think some of these companies are going to be thinking in terms of a stock holding company and not giving up the mutual form. At the same time, you have major companies like State Farm that have been rumored for five years to be converting, and yet remain adamantly mutual companies.

CHART 1
ASSOCIATION DISABILITY CHALLENGES
PHYSICIAN RATE COMPARISON—AGE 40

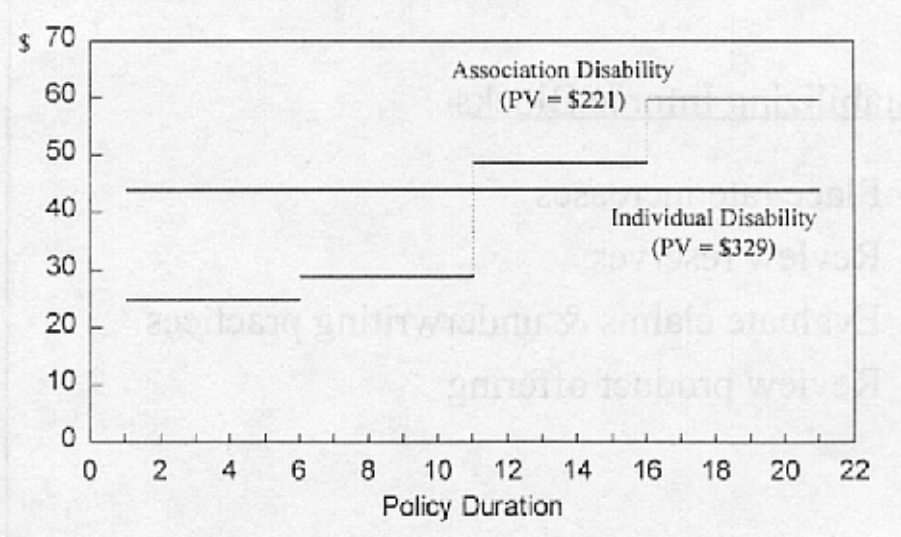

CHART 2
ASSOCIATION DISABILITY CHALLENGES
COMMISSIONS ON $100,000 OF NEW BUSINESS