RECORD, Volume 24, No. 3*

New York Annual Meeting
October 18–21, 1998

Session 6PD
The Future of Disability Insurance: Elements of Success

Track: Health Disability Income/Futurism
Key Words: Disability Insurance, Futurism, Risk Management

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Summary: The traditional approaches to both individual and group disability income insurance markets have proven to be unprofitable for many companies. Future success will require new visions of the disability market and the ability to implement completely new marketing strategies free from yesterday's bonds.

The panelists are leaders in disability insurance representing companies charting new directions in this business. One panelist takes the individual disability income perspective and the other takes the group disability income perspective. They present their visions of the future of disability insurance with respect to markets, risks, products, and profitability, and outline viable strategies for success.

Mr. Robert Crispin: I'm pleased to talk about individual disability insurance (DI). Peter Lynch, who, as you know, is a Fidelity Investments guru, spoke recently about disability, and he did it, by the way, before the recent market volatility. In his opinion, working couples with no disability coverage should consider putting money into a disability package before they buy more stocks. Unbelievable. How much would it have cost to get someone like Peter Lynch to make such a statement? A remarkable, remarkable development. We were very pleased to see it. The awareness of disability is rising, and the need for the protection is rising as well. We at UNUM are extremely optimistic about the market opportunities for DI.

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†Mr. Crispin, not a member of the sponsoring organizations, is Executive Vice President of UNUM Corporation in Portland, ME.

Note: This is not a true transcript of the session. Mr. Pollock's presentation is not available because of recording difficulties.

Some of your companies that have DI as one of their businesses probably have life insurance as well. I'm not sure in all good faith you can—because I certainly cannot—say the same optimistic things about the future of life insurance as one might say about the future growth prospects of DI. But the disability business is a tough, tough business. It's complex. It's scary. There isn't a day that goes by as we track our daily claim results that one can't ask, "Why are we in this business?" UNUM is the leader in the business, and we are very good at it, but it is a frightening business. I spent a lot of my life on the annuity side, both fixed and variable, and there you're clearly subject to a lot of factors that cause your results to move around a fair amount, but I can't say that any of those businesses, at least in the 30 years that I've been in the business, can create the kind of concerns day to day that disability does. But we're in the business. We love the business. Hopefully we are good at it. Certainly our shareholders pay us a very high price/earnings (P/E) multiple because they think we're good at it.

Now, I listened earlier to Fortis, which has been a great success in the business. Everybody has different ideas as to what the right strategies are. At UNUM, we would not say that our strategies are the best for everybody, and we would certainly not say that our strategies make sense for everybody. What are they? Well, in a broad way, we think that for us having great expertise, very deep expertise, being innovative, and being willing to take bold moves, some of which might better be called just being a leader, is what we do. The individual disability business, which I'm going to talk about, is one where we have taken some bold moves. We've had some experiences that have been extremely painful, but we learn, and hopefully we're a far better organization because of it. UNUM's leadership position on the group side is unparalleled. We've been the leader in that business for 22 straight years. We're the first to develop a disability business in Japan, although I wish it were going better in Japan. Certainly the economic environment is slowing down. When companies can't get credit to fund their working capital, which is true in Japan today, it's hard to get them to add new employee benefits. Sooner, rather than later, the Japanese disability market will take off. We're a leader in the U.K., and obviously through our Colonial organization, we're a major player in worksite marketing.

The three elements that we say make UNUM distinctive are our disability knowledge, our risk management skills, and our distribution prowess. We could argue a little bit about how deep we are in all three areas, but to me with the first two, risk management and disability, there's absolutely no question. We are just as strong on the distribution side, if you define distribution prowess as brokerage distribution, but we are not as strong in other forms of distribution, where it's very likely that some of the fastest growth will come. If you look at UNUM over the next

few years, you should certainly expect to see a much broader base of distribution than you see from us today.

Market Potential

As far as the eye can see you can argue again as to the extent of the industry's penetration in these businesses, but the first, the individual disability business, is only about 35% penetrated. Group disability, including short-term disability (STD) and long-term disability (LTD), is about 50% penetrated.

In markets abroad, there's a lot of opportunity as well. Certainly UNUM's focus is Japan, the U.K., and South America. We've recently purchased a company in Argentina. In many other places, there's a government-sponsored social net for health, welfare, and pension products. Now, it's ironic when I say that there are opportunities in these places because governments can't afford to accept those responsibilities any longer. Recent election results in many of these countries show you that the winners have been left of center, and there may be a delay in getting to the privatization of these markets relative to what I otherwise might have expected, but they will get there sooner or later. We're looking at a lot of places globally, but our greatest opportunities, and I would suggest yours as well, are right here in the U.S.

Now, I would like to make a point about the underserved nature of the disability markets and particularly the individual disability market. There is a relatively high level of concern in the population about financial misfortune, but premium is not increasing in proportion to the nature of that concern. You might draw some different conclusions, but I see more confirmation of the market opportunity relative to the concern, particularly in contrast to the life insurance side of the business.

Now, what has UNUM tried to do historically to support the expertise, innovation, and leadership? I mentioned the strength of our risk management, our disability knowledge, and our distribution, all of which we have worked to sharpen. If you looked at the development of our people, you would see that we try to have our people become immersed in all of those disciplines as they go through their careers at UNUM.

There was a comment by Rob Pollock about types of disabilities that are more difficult to adjudicate, and he was nice enough to mention the work that UNUM has done in this arena. This is our experience. Carpal tunnel syndrome has grown by 400% over a period of about five years; similarly for other claims, such as back and disk and so forth. These are claims that were not on UNUM's radar screen more than five years ago. We thought of them, but we certainly didn't have the

expertise to deal with them, but if you don't have the expertise today, you're in big trouble, because this is where the claim experience is coming from. The other claims, such as strokes and diabetes and heart and other circulatory illnesses, are playing out pretty much as we'd anticipated. Now, to be sure, when you had changing developments like managed care and the impact that it had on the physician community, even those disabilities that are more easily adjudicated jumped up, as a number of the physicians who previously worked through those issues no longer said, "I want to go and stand and operate for ten hours of the day."

Segmentation

We talk a lot about both pricing segmentation and market segmentation. We spend a great deal of time on it. There's great opportunity to do it, but in order to do it, you need the databases that really give you the statistical significance to draw conclusions. We have the great fortune at UNUM of having one of the world's largest disability databases, second only to the Social Security Administration database. Ours is the largest private database. Our actuaries have a field day and are valuable to UNUM because of their ability to play with that rich data source.

Claims Management Expertise

We talked briefly a minute ago about these more subjective claims, and you need both contract design and special resources in-house to deal with this world. I think we now have more than 60 physicians on staff. I don't know how many nurses and other healthcare experts, but it's in the hundreds. They have skill sets that are clearly critical to our success. It's been an education for us in managing physicians, compared with their own self-management in the past, but we've also been able to cut through that. Mental and nervous claims create a whole new world. Who knows where this is going by law? The courts will sort that out. We say that the playing field's level, and mental/nervous is treated like all other maladies; that is, treated the same for all of us in the business. So be it. Fine. We'll play, and I think we'll play well. But we will still expect that one to cause us some heartaches over time.

Distribution

Distribution has to be broadened. We have to get to market segments that we don't now serve. Forget whether physicians are good or bad risks. Market penetration in physicians is nearly 90%. It's not going to grow. Other white-collar occupations—lawyers, architects, investment types—also have high penetration. But there is very low penetration, to take it to the other extreme, in police departments. How do you play in that world? That's a whole new opportunity for us. Distribution will be different to get there as will the contracts that are developed. Banks. None of us have done a lot with banks yet. Certainly there are some companies that are much

further along than UNUM in this market; we do not have a successful effort there. Financial planners are probably a great opportunity for our industry, as well as stockbrokers. But we don't relate well to that market at this point, at least not at UNUM. We will need to as we proceed.

Innovation

We think our product form in the individual disability arena, which is called Lifelong Disability Protection (LDP), is quite innovative. Now, we got there because we probably weren't doing a great job before. Any of us who have been in the noncancellable side of the product form have some real scars to show, but we were not willing to temporize on that. We said we cannot play a you-bet-your-company strategy on noncancellable disability products, plain and simple. If you think of it in an investment sense, and I tend to come back to that because that's my root, effectively we're selling a long duration option for no money. That, at least to an investment type like myself, is very frightening. Now, we have no plans whatsoever to use price competitively in our guaranteed renewable product form, but we certainly don't want to be precluded from it if events so warrant. I'm also quite intrigued with a recent development that I think is of monumental consequence to our industry. This is the decision by one of the major, if not *the* major, individual disability reinsurers to exit the business for new business come January 1, 1999. I expect many companies that were still in the business with the traditional noncancellable form are not going to find reinsurance capacity come the start of the new year, or, if they do find it, they're going to find it a lot more expensive than they've found it in the past.

In our LDP product, UNUM provides 60% income replacement, except in the case of the inability to perform two activities of daily living, which is the standard definition of a long-term-care (LTC) benefit trigger; then it can go up to 100%. So, you have a truly catastrophic approach on our product, and we're getting a lot of play from that. Certainly in this world, which arguably is somewhat more commodified, having this kind of differentiation is critical. About a third of our LDP sales are packaged with group disability. By the way, for those of you who are shareholder-owned companies, at least right now the analysts and investors spend a great deal of energy and focus on cross-selling. I'm sure our P/E is positively affected by the extent to which we are cross-selling both individual and group DI.

The Disability Model for LTC

When we got into LTC about ten years ago, there were some players like CNA that had been in for a while, and they certainly knew the business. How were we going to play? We said, fine, let's play with our disability strength and experience, and that's served us very, very well. Certainly our innovation here allowed us to get into

a business that has terrific growth prospects. But, we're not here to talk about LTC, although LTC growth prospects are terrific. Our innovation also let us play to our strength and use the same data source in creating our pricing, as we had, of course, for our disability.

Bold Moves

Every company does some things very well. We don't have a corner on good, smart decisions, but I take a great deal of pride in seeing that we as leaders are willing to take some very difficult steps. We do it aggressively, even when there is pain following those steps. Our decision to exit noncancellable disability product form in 1994 also led to the downsizing of our distribution force. I am sorry that that was an outcome. I'm not sorry with the decision to exit the product, but we had to rebuild what was a pretty darn good distribution system on the individual side. So, there were some things we did that had some downside consequences, but we feel very good about the basic decision. We've also exited lines of business where we had no business playing. People in this audience and others at this meeting are so much better and will be so much better at annuities and businesses like that. We'll play in the disability world. Rob mentioned "focus" again. You'll see us focused on morbidity products, where we think the three competencies mentioned earlier stand us in good stead. When UNUM got out of noncancellable, many companies also decided that it was not a business in which to play. Now, they didn't do it because UNUM did it. They just finally realized that they were seeing the same kinds of things in their results that we were seeing. We just saw them a little sooner.

Guaranteed renewable disability products are clearly accepted today. It's rather disconcerting to see the decrease in new individual disability sales over the last three years. Who would have thought individual disability sales would have been down this much—$465 million to $286 million? But look at how much is coming from the guaranteed renewable (GR) side. When I go out, as I do, and spend a great deal of time with brokers, they're finally saying, "OK, we get it." Now, again, it's not because they love UNUM necessarily. They can't get business through underwriting. Prices continue to go up. I'm sure you've noticed that one of the most recently announced decisions concerns a key individual disability competitor's plans to significantly raise prices again, as of January 1, 1999. Now, I suspect that there are more increases to come, and they will probably continue to hurt the overall disability sales world, but the GR product form is clearly established.

UNUM is an interesting company, particularly now when we're perhaps looking at an economic decline and maybe further interest rate reductions, but if you talk to our investors and our analysts, they will tell you that they expect we'll do pretty well in this environment. We expect to do well because this is a business that we

will continue to invest in. UNUM, by the way, doesn't think it's a commodity business. Certainly UNUM's margins would not indicate it's a commodity business. But hopefully over time, those of you who are the good players in the business will continue to want to play because there's nothing like good, rational competition. Hopefully our discussion will get into some of these other points.

Mr. Daniel L. Wolak: Bob mentioned that UNUM has the second largest database of disability information. Rob, you mentioned that one thing that actuaries aren't doing, you feel, is drilling down more on the information. One question from your viewpoint I guess at Fortis and maybe just generally: How good is the information that is available? What are the challenges that we have in getting—or finally getting—the kind of information that we can really drill down to have the type of knowledge that possibly a UNUM has right now in the marketplace?

Mr. Robert Pollock: Well, that's a loaded question, but I'll take a shot. First of all, there's no doubt about it. UNUM has the largest private database. On the other hand, I would argue that two fundamental things are at play here. One is there are many ex-UNUM alumni out and working. So, that information is available in the secondary market. It might not be quite as timely. More important, UNUM does a great job of recognizing new things that are coming and developing ways of dealing with them. I would argue there's going to be more and more of that, and as things change faster and faster, like with anything else, historical information is important but a bit less relevant. So, I think you can get the information. You talk to reinsurers, you visit with other companies, and you develop those informal networks. The industry is pretty good about trading and sharing information. At Fortis, we tend to think our own database is pretty good as well, but we're always looking for ways to supplement. I think that's part of the job of actuaries, salespeople, etc., but I also think that, again, as things change moving forward, it's really not about looking to historical data, but rather to spotting trends that are developing. It doesn't have to come just from the information.

Mr. Howell M. Palmer: Obviously, particularly in the individual business, the industry is taking a real bath from the medical professions. New people coming into the medical business (such as residents and doctors early on in their careers) are coming into a very different environment. Do you think they are likely to have more favorable claims experience in the future than their older counterparts, who obviously came in before the managed care world existed?

Mr. Crispin: The problem with physicians was not that they were physicians. It's just that we had a third of our block in physicians. I think having come from the Travelers, where real estate was undiversified, I see the same was true of physicians.

Had we all had 5% of our block in physicians, we would have taken notice, but probably would have continued to play. So, the issue for me is diversification, as opposed to any particular occupational class and saying it is good or bad—just having a broader spread of risk. Once again, the problem wasn't physicians. The problem was the nature of the contract. We would believe, speaking to your point, that a good case can be made that the new type of physician who's in a staff kind of role, as an employee, not self-employed, is likely to have better risk results. I just suggest that even if that's the case, we would be loathe to play with a traditional product form.

Mr. Pollock: I guess I'd make a couple comments. First, I believe medical is a superior risk. By that, I mean the demand will continue to go up and up. With that being said, however, I think physicians as a percentage of the population are growing too fast. There are more physicians per whatever measure you want to use of the population than there has ever been before. I think that in itself has ramifications. I think if you add to that all the things that are going on in biotechnology, this business is going to change. The traditional physician/patient relationship—in 20 to 30 years, I don't know when—is going to change, and I think that will have an impact.

Mr. Daniel D. Skwire: Bob, you talked about one of the elements in the future success of DI being international expansion. One of the interesting things about UNUM is that there's no ownership relationship or subsidiary relationship with a large multinational kind of owner. Could you talk a little bit about how UNUM has begun to explore international markets and about the type of investment horizon that's involved with that sort of investment?

Mr. Crispin: Well, I'm sitting next to a real international firm. So, it's a little bit humbling to talk in front of Fortis, but our international focus has primarily been through acquisition, where we can quickly get a fairly significant presence. In our foray into the U.K, where, by the way, we have about the same market share percentage as we have in the U.S. on the group side (about 28%), we bought a company. In the case of Argentina, we bought a company that actually is not even in the disability business yet. They're in the workers' compensation business because there hasn't been a private disability market in Argentina. In the case of Japan, we set up a company with two different distributions: direct and reinsurance, where we've hooked up with the major non-life company there. They're the ones who are licensed in Japan to sell disability. We've set up arrangements where we provide the product and the expertise, and they're reinsuring back to us by agreement about a third (25–50%) of the risk that they generate. So, we've played internationally in different ways. In continental Europe, the last place where we

don't have much yet to show, we don't have a firm strategy developed yet. More likely our activities there will be in coordination with some players who know a lot more about that market, because we certainly aren't going to be able to buy anything in Germany, France, etc. We just wouldn't be able to buy any company that would allow us to be a major presence. It's just too expensive.

Mr. Vincent A. DeMarco: Both of you talked about distribution and alternative distribution strategies as being the key to success. I was wondering whether you think that some of the mutual funds or other companies could get into this market with alternative products, and do you see them as a threat?

Mr. Pollock: Well, in many of the alternate channels I think our biggest problem is that the product is too complicated. Let's take banks or mutual funds: People understand what they're buying in both those situations, and in our discussions with banks, they get real concerned about selling something that causes a problem later on at claim time. ("I didn't understand what I bought," etc.) I think there's huge opportunity to get in there, but I don't think it's with the product form we're offering today. I think it has to be simpler. I think it has to be more of a peace-of-mind solution that fits in with the things they've traditionally distributed.

Mr. Crispin: I would mirror that. I would say there is a great natural affinity and mutuality of interest if you think of the investment-type organizations and the morbidity-type organizations. Think of stockbrokers, for example. That old adage is: once you see a sell ticket, you don't ever see a buy ticket again, except in recent markets where people are heading for the hills. But when people start dissipating their assets, thinking particularly of LTC, what happens to those investment firms? They lose fee income. If we can structure a way to align our product form, which doesn't align well at this point with those providers of investment management, it could be a home run.

Mr. David Scarlett: With Peter Lynch saying that disability needs should be met first before buying stocks, I just wonder if Fidelity has any designs on the disability industry.

Mr. Crispin: We hope not.

Mr. Martin David Werth: I thought Rob's talking about the Netherlands was very interesting, because it showed that maybe it's not just the product we have to think about. What the Netherlands actually did was introduce new laws. They introduced first of all a Medical Examination Act that actually said that no longer are groups—or employers of group schemes—allowed to underwrite their employees.

Therefore, we could never find medical information. Second, they made it an obligation (with a fine) for employers to have rehabilitation programs, and if that wasn't good enough, they would be fined. Third, they made it an obligation of the employee to find alternative work in the firm. So, it wasn't about what you couldn't do. It was actually about what you could do. They also gave tax incentives to disabled employees. And my own feeling is that until we see a big change like this, the question is, do we still have a flawed product, where we're constantly looking at what they did, not looking at what they can do?

Mr. Pollock: I don't have a good response to that, but I will say that if you look at what happened in the Netherlands, first of all, there was encouragement for the government to change from a social program to a privatized system, and they passed these laws. Many of these politicians are no longer in office because when the people found out what they had done, they weren't happy about it. That being said, my understanding of the market, and I've only been a consultant on the back end to some of our experiences over there, is that the big play was toward market share. The restrictions that you rightly pointed out were for a flawed system. Whoever picked up the risk was almost obliged to lose money; how you change those things, I don't know, but I think we face some of those same challenges in the U.S. today. If you look at the limitation argument that's going around, I think it's inevitable, for instance, as Bob mentioned, that we'll cover mental/nervous, and when it comes we'll be ready as well. But the U.S. laws are changing in midstream, too. You've written a contract with something said, and now at claim time a lot of that is being rewritten, much as it was in Holland. That's a difficult situation to deal in and does point to a flawed form.

Mr. Gene Carey: I'm on the employer side. I was wondering if you could speak to the future of managed disability and integration of occupational and nonoccupational DI.

Mr. Crispin: At UNUM we do not have lots to show for managed disability, if you define managed as health, compensation, and disability. We've had some forays: We had an operation in California called a single point, which was an amalgamation of those three different types, but it didn't work well for a variety of reasons. Where we have made great strides in managed disability is the integration of STD and LTD, and, in fact, we have what we call the one-benefit center, which is truly that, on behalf of the employer. We have also taken some steps recently from an informational perspective. We purchased a company called Options & Choices, a software firm in Wyoming. The information that they are providing to the employer, which is the sum of the absence experience occasioned by compensation and health and disability, is proving to be of great value. We haven't done more

than that at this point. Other than regulation, why shouldn't occupational and nonoccupational be one? Sometime I suspect that it will be. We don't want to be in the compensation business right now because it would kill our profit margins, but we certainly have to be better at it. We do not have, for example, Fellows from the Casualty Actuarial Society on staff. We should have that capability, because sooner or later I think that will happen.

Mr. Pollock: First of all, I think there is no common definition of managed disability. So, what does it mean? Well, it's a panoply of different answers. I think Bob is right, in that early intervention is the biggest thing that can be done to managed disability, and I think the industry has moved toward a closer integration there. When you look at the nonoccupational distinction, I think that's going to come at us from a different standpoint. I think it will come actually from the property and casualty carriers that realize they may pay for a fair amount of nonoccupational disabilities that get reclassified as occupational disabilities. So, I think there may be some moving around in those areas. What is managed disability? It's a good question. I think there are a lot of things on the horizon, and I think it's really about getting in and fundamentally understanding early intervention and understanding emerging claims that have hit the scene.