RECORD, Volume 25, No. 2*

Seattle Spring Meeting
June 16–18, 1999

Session 102PD
Reinsurance for Group Voluntary Products

Track: Reinsurance
Key Words: Disability, Long-Term-Care Products, Reinsurance,

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Summary: Voluntary products are gaining popularity in the group insurance markets. Products such as critical illness, group accidental death and dismemberment, and group long-term disability are becoming group voluntary offerings. How do reinsurers assist in this market? What forms of reinsurance are used? These questions and many more are answered during this panel discussion.

Mr. Michael D. Lachance: A tight labor market is forcing employers to provide additional benefits to employees in order to attract and retain employees. The rising cost of these benefits makes it difficult for some employers to provide these benefits on an employer-pay-all basis. Thus, there has been a rising interest in employee benefits provided on a voluntary, or payroll deduction, basis. Our panelists will discuss the ways in which reinsurers can assist insurance companies in developing and managing voluntary products.

First to speak will be Al Barthelman from AB & Associates, a marketing consulting firm based in Cape Elizabeth, Maine, specializing in work-site marketing. He will present an overview of the issues and trends in the work-site marketplace. Our second panelist will be Scott Wiley. Scott is from Disability RMS, a reinsurer located in Portland, Maine, specializing in group disability reinsurance. Scott will discuss the ways in which a reinsurer can assist you with a voluntary disability product. Our third panelist will be Andy Niedzielski representing CIGNA Reinsurance of Hartford, Connecticut. Andy will provide a case study of the development of a critical illness voluntary product to illustrate the ways in which a reinsurer can assist you with a critical illness type of product.

Mr. Al Barthelman: I'm going to give you a quick overview of the work-site marketplace, and then Scott and Andy will get into some detail on specific products. By way of background, I'm not an actuary. I focus on the marketing processes and services associated with voluntary and flexible benefit products. I work with insurance companies that want to improve their results in the voluntary benefits marketplace or get into the business if they are not already there. I'm speaking as an outsider looking in at the industry. I want to make some fundamental points to help clarify what is generally going on in the market.

I'd like to start with a very basic definition of what we mean by voluntary benefits. Then I'll give you the compelling business reasons why you should be offering voluntary products. Then we'll get into

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

some of the fundamental differences between individual and group voluntary products. I believe there's a lot of confusion around whether to offer individual or group products. After I clarify the differences between the two product types, I'll end by talking about the specific challenges associated with marketing group voluntary products.

Chart 1 is a diagram that I use to describe the different ways products can be funded and how the funding can be shared between the employer and employees. The lighter shading depicts employer money and the darker shading depicts employee money. The box on the left represents traditional employer-pay-all benefits. As you move to the right, you see two ways in which employers share the cost of premiums with their employees. At the bottom, a contributory plan is one where the premiums are split on a percentage basis between the employer and employees. That split can range from the employer paying nearly all of the cost to the employee paying nearly all of it.

Above that, you see the base/buy-up concept, sometimes called flex. In this case, the employer funds a basic amount of insurance, and employees can "buy-up" with additional amounts of coverage. As you move across to the right of the chart, you see employee-pay-all benefits, or what most people call voluntary.

One of the reasons I show this picture is that a lot of companies are still struggling with which products to define as voluntary. A lot of the same issues that are involved with voluntary products also come into play with base/buy-up and contributory plans. For all of these products, employees must make a buying decision. Companies often overlook the issues surrounding enrollment and participation for contributory and base/buy-up products because they have not put them in the same class as voluntary. However, for the sake of discussion, we're going to be talking about pure employee-pay-all voluntary products.

One other point I would like to make is that one company's voluntary product may, in fact, be the employer's buy-up option. That is, the voluntary product may be in addition to an employer-funded base plan. I think that's an important thing to remember when talking about risk management and pricing for voluntary products. They should be considered in the context of other benefits that an employer is offering to their employees.

Another spectrum I'd like to mention before we move on is the spectrum of product complexity. Everyone knows that, in order to succeed in the voluntary marketplace, you need to keep your products as simple as possible. Make it easy for the consumer to understand and easy for the employer to administer. However, there is clearly a range of understanding of the need for various products. A product such as term life is simple in its own right and the need for life insurance is well-recognized. On the other hand, products like long-term care (LTC) and universal life are more complex, and the general population is not as familiar with their need for these products. I feel that disability and critical-illness products are somewhat in the middle of this spectrum of consumer need and understanding.

Here's my simple definition of voluntary: Voluntary products are insurance products that are sold to employees at the work site and paid for through payroll deduction. The important thing is to focus on the employee as the buyer of these products. We must design them for the employee and think of the broker and the employer both as intermediaries. The challenge is to sell effectively to the end consumer through this extended channel.

Now, let's talk a little bit about why you should be in the voluntary market. The Life Insurance Marketing and Research Association (LIMRA) has done a great deal of research into this market. Its early findings are still holding up. More than half of all employees would prefer to buy their benefits at

the work site, and there are some obvious reasons for that. First, discretionary time is becoming as valuable as discretionary income. The opportunity to purchase insurance during the workday is a big plus to a lot of employees. Second, with payroll deduction, premium payment is "out of sight, out of mind." Third, the employer's endorsement of the product gives employees comfort that the employer has done the shopping for them.

The other consideration in entering this market is market potential. Eastbridge Consulting, a firm in Connecticut, did some research into market size last year. It showed that about $11 billion of voluntary benefits was in force at the time. In the next two years, 40,000 employers will add voluntary products, and in the three years after that 80,000 more employers will add voluntary benefits, so the market should grow by $22 billion over five years. A.M. Best released a study in July 1998 indicating that a third of all voluntary plans currently in force were sold within the last year. There's obviously a lot of sales activity right now.

However, having said that, I'd like to add I don't think there's a good, comprehensive source of data on the voluntary market. A good deal of the data that is published focuses on the individual products market, where carriers have good tracking systems. Systems used by group carriers typically don't track insureds at the individual level, and voluntary business is often not segregated from traditional business. Therefore, research that has been done to date is somewhat anecdotal.

I like to think of the voluntary offering as having two components: One is the insurance product itself, and the other is the processes that we wrap around those products. Both are very important. To the extent that the employer is making a decision to offer your product, if it's a group product, you have to have the processes in place to make it easy for that employer. That means effective communication to employees and simple administration. We must be excellent in both product and process in order to succeed in this market. I would also suggest that business must be underwritten with regard to process as well as product. Finding employers who will promote and market your product to their employees is critical to achieve the participation that you want to have.

Let's talk about some of the differences between individual and group voluntary products. A lot of people attending conferences on work-site marketing or voluntary products get confused because the processes associated with individual voluntary products aren't distinguished from those for group voluntary products. For example, one-on-one meetings with laptops are described as the best way to enroll, when, in fact, group voluntary products aren't usually priced for this approach. The A.M. Best study talked about the voluntary market as a whole and did not distinguish individual from group. It said that the three best ways to enroll are one-on-one with a laptop, group meetings, and direct mail, in that order. In fact, there are different best practices for group than there are for individual.

Basically, marketers of individual voluntary products see the workplace as an extremely efficient way to distribute to individuals. Rather than sitting down in the evening at somebody's home, an agent can see many people during a day at work. The high/low commissions typical of individual products provide agents with the incentive to provide value-added services at the work site, such as core benefit enrollment. On the other hand, if you look at the group side, voluntary products mean more work for less premium. With traditional group employer-paid benefits, the employer makes the buying decision and premiums cover all employees. For a voluntary product, enrollment services must be provided and premiums come from less than 100% of the employees, so there is less premium for more work. I don't mean to be discouraging about the group voluntary market, because I do believe that this is where the market is headed, but we have to get very good at the processes associated with group voluntary products and make sure that our offerings are priced appropriately to cover the cost of the processes and services that we choose to offer.

Another way to look at the work site market is to consider the relationship of individual supplemental products and group voluntary products to what I call "core benefits." This is a very simplified picture of the marketplace. First of all, I'm defining core benefits are those benefits that are generally taken for granted, such as health coverage, a retirement plan, and any coverage that the employer is paying for. The employer may not want to pay for a middle ring of core-like coverages, such as disability, life, or dental coverages. And there is an outside ring made up of supplemental benefits that tend to be gap-filler products, with relatively low price. Examples include cancer insurance and hospital indemnity plans. These have typically been individual products and are put on the outside as a wrapper, if you will, of the other products. And there's a lot of blurring between group and individual. A good example of that is critical-illness insurance, which is being marketed from both a group and individual platform.

Another way to look at this is that group voluntary products are an extension of traditional group benefits without the employer paying the premiums. For years, group carriers have struggled with the fact that their voluntary products are essentially copies of their traditional products with several features added, such as portability and a pricing load for reduced participation. In fact, group voluntary products are most often being sold by the group broker, who is already familiar with your traditional products. That familiarity with the product type can increase the broker's comfort in selling the voluntary version of your products.

On the other hand, marketers of supplemental products face the issue of how to connect their products to the benefits that an employer is already offering. Since these are supplemental products, an agent will offer value-added services in order to connect his or her products through services to the employer's core benefits. The marketers who offer supplemental products are normally sitting down with a laptop and talking one-on-one with employees, communicating core benefits as well as the products that they are selling. These marketers are usually work-site marketing specialists or benefit-communication firms. This approach is appealing to many employers because they don't have many opportunities to communicate their core benefits effectively. I should mention, too, that individual supplemental benefits are most often offered as an array of products. Group voluntary products are typically offered one at a time in a building-blocks approach.

Let's move to some of the challenges presented by group voluntary products. I already mentioned it's a three-tiered sales process. You have to sell the broker first. Then, in turn, you have to sell the employers to get their commitment, and, finally, you have to sell the ultimate consumer of the product, the employees. It's a long distribution channel, and in many ways it can be like pushing a brick with a string. It's very difficult to sell effectively at all three of those levels and have it turn out well. The second challenge of group voluntary, making administration easy, is very important. Most of the research has shown that fear of the complexity of administering a voluntary product is the top concern of most employers and, frequently, the reason for not offering voluntary benefits.

Third, risk management is considerably more complex for group voluntary products than for individual products. Individual supplemental products usually use simplified underwriting and book rates. Group products must be underwritten at the group level, and we often do individual underwriting as well. Additionally, group results depend extensively on participation levels. This leads us back to my earlier comments regarding the importance of the underwriting process as well as the product.

The last challenge is business focus. For most group carriers, responsibility for voluntary products is blended in with the rest of the organization, and there tends not to be the kind of focus that you

need. An area of particular importance is, who's managing the business and really looking at it? Do we have the systems in place to track the results of our voluntary business and how it's performing?

The relationship between participation and price, I hope, is fairly obvious. There is considerable leverage in getting increased participation. Increasing participation from, say, 30% to 40% will significantly improve the loss ratio on voluntary business. Obviously, there's a tremendous incentive to work at getting higher participation on your voluntary products. One interesting thing is that, if you increase a product's price because you assume it's going to have low participation, guess what—the higher price will make the product less attractive to employees and you will get lower participation. The pricing of your product can become a self-fulfilling prophecy: Higher prices may drive down participation while lower prices may drive it up.

The rewards for successfully marketing quality voluntary product are great. Success on the group side relies on high participation. Conversely, individual carriers often get higher participation and are more concerned about persistency. That's because the individual sales process can be more aggressive. On the individual side, one-on-one sales are more effective, but people may drop the coverage more frequently once payroll deductions begin. On the group side, enrollment is more difficult, but employees tend to keep the coverage longer. In either case, if you do a good job at all of it, you have a chance for very profitable business, and this is a market that's going to grow considerably, given employers' interest in maintaining or controlling their expenses.

Mr. G. Scott Wiley: I'm going to talk about one particular use of reinsurance—group voluntary disability products.

Voluntary products make up an increasing proportion of the total disability market. In the early 1980s, many companies didn't worry about voluntary disability products. Today they have become very popular, and the growth of these products is expected to continue as employee-benefit costs shift more toward employees. Therefore, I believe it is mandatory today for any company that is serious about growing its disability line to develop a strong voluntary program.

If you agree that group voluntary disability is a product worth pursuing, the logical question might be, "How do I enter this market?" There are many ways to get this done but one good way to get started is through disability reinsurance. A good disability reinsurer will be able to assist you in the development and implementation of group voluntary disability products.

The development stage can be broken down into three smaller stages: concept, product, and pricing. During the concept stage, a dialogue takes place between insurer and reinsurer. Discussions should center around the needs and capabilities of the insurer. The identification of target markets and any existing niche markets where the insurer may have a competitive advantage is helpful information. Once the marketplace is adequately defined, then the demands of that market are identified. Any existing competitive information on the key voluntary writers already in that marketplace is also helpful.

The best of these products could serve as your starting point for the development of your new product. Short-term, you can always copy a successful product that has been filed and approved. Long-term, you will need to come up with a new bell or whistle that will separate you from the competition. A reinsurer is often a good source of new ideas to help create this competitive edge. Of course, whatever is developed must fit with your existing distribution systems. That is where the product development stage begins.

There are two main types of voluntary product distribution systems. The first is called a work-site marketing system. This system is characterized by one-on-one enrollments conducted by a broker, TPA, or maybe an enrollment company on behalf of the insurer. One-on-one enrollments are very expensive, but if they are done well, increased employee participation and lower claim costs will result. One-on-one enrollers are often given a higher first-year commission as an incentive. These first-year commission levels are much higher than what is traditionally paid on a group disability product. They tend to be aligned with individual disability commission levels. In fact, individual disability writers often compete for the same business in this marketplace.

The second type of product distribution system is called the group distribution system. This system is characterized by group enrollments conducted by a company sales representative. Enrollment expenses are much cheaper in this system, but you get what you pay for, and what you often get are lower participation levels and higher claim costs. The commission schedules in this system are not unlike those paid for traditional group disability products. Level commissions of 12%, 15%, and 20% are often used, as is the standard 15% graded schedule. Total expenses tend to be a little higher than traditional group products, but are still well below those used with work-site marketing.

There are many other differences worth mentioning between these two systems. I won't cover every difference but there are a few points worth mentioning. Consider the type of rating structure generally used for products created for these different systems. With work-site marketing, your field force and customers want something that is simple and can be sold immediately. The actuaries often need to resort to aggregate pricing assumptions to create this simplicity, which also means higher, more conservative rates. Because these structures are simple, the rating is less precise and your financial results may be more volatile. This means you will need to build higher profit margins into your pricing. The good news is that your competitors are also out there with a conservatively rated product.

With the group distribution system, on the other hand, you are probably using the same rate structure used for your traditional disability products. These structures tend to be very complex, as anyone who has ever looked at a group disability rate filing can affirm. Since rates are very precise, financial results are less volatile and margins can be reduced. However, the companies that participate in these markets are fierce competitors, and the lowest rate often wins the case. Although this market desires same-day quotes, rating is census-driven, so there may be a one- to three-day lag before rates are available. Any insurer that can produce accurate, competitive rates by age band at point of sale will have a major advantage in this market. Some reinsurers may be able to provide software that can provide this capability.

Once a product has been designed to fit your distribution system, your reinsurer can then move to the pricing step. Pricing can be further divided into two components: risk and expense. When you're considering the risk for a voluntary disability product, you first need to consider minimum participation levels. These are often set as a minimum number and/or a percentage of eligible lives. At one time, the participation bar was set at 25 lives and 25% of all eligible lives. Today, this bar has been lowered; sometimes there aren't any minimum requirements. That should make a group disability actuary a little nervous. Fortunately, a reinsurer can help you develop logical guidelines to manage these situations and other exceptions that may arise. Requiring evidence of insurability is one popular solution in some of these situations. There has also been an increase in the use of strong preexisting exclusion clauses in lieu of, or in addition to, medical underwriting. However, this is one area where it doesn't pay to be the one carrier in the game with a unique risk solution. In these situations, either the market will select against you, or you simply won't write any business.

Common sense is always important when determining the range of benefit options for your product. It may be very fashionable to write plans with high benefit replacement levels, but you probably won't like your financial results. It makes little sense to make it financially equivalent to remain disabled or be back at work. A good reinsurer will know where to draw the line. Similarly, the degree of choice between employers and employees needs to be balanced to control the adverse selection inherent in a voluntary product. Simply following the competition may not provide the best answer for a new entrant because there are some very liberal plans in today's marketplace.

Once risk has been considered in your pricing structure, you can then move to expenses. One thing to consider is the incremental cost of increasing enrollment levels. You must be careful to ensure that the expense costs don't outweigh your expected risk improvements. Similarly, although higher commissions and expenses are needed, at some point you may price yourself out of the market. This may become especially apparent in larger cases. A 15% flat voluntary commission that works for a mid-sized case probably won't fly for a million-dollar case. Some expenses cannot be avoided and must be included in your rates, such as premium taxes.

When it is all said and done and your expenses are added together, they must still comply with minimum loss-ratio requirements. Some states are very strict about what they consider to be reasonable expense and profit levels. Occasionally, exceptions will be allowed below minimum loss-ratio standards with supporting justification. However, with voluntary products, especially group products sold through the work-site marketing system, it can be a significant challenge to develop a profitable product that complies with these laws. A reinsurer can prove invaluable in these situations and can work with you and the insurance departments to develop this product.

Now that we have completed all the stages of product development, we can move to the process of implementation. We now have a new product with underwriting or risk guidelines, and we have a competitive price. The implementation stage now considers four areas: contracts and filing, training, marketing, and risk sharing.

With contracts and filing, a reinsurer can help you develop group voluntary disability materials. They may have "canned" documents available to facilitate this process, although customized materials may need to be created. The reinsurer's expertise to develop actuarial memoranda to meet the requirements of state insurance departments can be invaluable. Anyone who has done disability filings lately knows that insurance regulations are much tougher than in prior years. Reinsurers tend to be quite knowledgeable in this area because they are continuously filing materials on behalf of their insurance clients.

Training is another critical element needed to successfully implement a group voluntary product. Sales and underwriting tend to be the primary areas of training focus. With sales training, it isn't necessary to spend a lot of time talking about your distribution system. You already have this expertise. The main objective will be to increase your understanding of the new product. An overview of product options, and the relative value of these options, is an important start. Understanding the relative value of options gives you the ability to counter-offer meaningful plan alternatives if your initial rates are not competitive. Similarly, understanding and effectively promoting unique product options can create a marketplace advantage used to close a sale. Cross-selling can also be a useful tool to increase disability sales. As a disability actuary, I'd like to believe that disability products drive the insurance industry. Unfortunately, this is not the case, so an effective cross-selling strategy is often required.

Underwriting training may overlap somewhat with sales training in the area of subject matter. An overview of the disability risk and product is often provided to staff underwriters by an experienced

reinsurance underwriter. Some of the reference materials that might also be provided include underwriting manuals, underwriting guidelines, and rating crib sheets. Because voluntary has some very unique risks not encountered with traditional disability products, these will be highlighted during this training. Risks such as overinsurance and required participation levels cannot be overemphasized during the training process.

The provision of marketing materials is also another important service provided by a reinsurer. The extent of these materials will vary, depending on the needs of the insurer. However, both sales and rating materials are usually provided. With a brochure product, raw rates in spreadsheet form may be provided to a larger insurer who can create its own customized materials. Smaller companies may look to a reinsurer to complete the development and printing of these materials. Rating instructions and disks are also provided to reinsurance clients. For clients that have their own rating systems, systems expertise is provided to build a seamless link between the two systems. For the more technically inclined clients that like to do their own analysis, competitor rate filing materials can also be provided. Reinsurers tend to have a lot of these materials on hand to test their rate structures. They can also provide some insight about new product ideas and rate filing strategies.

Sales manuals and materials used by competitors can also be provided. You've probably seen in some of these materials some key statistics that are meant to raise awareness about disability. Most people already understand the need for life insurance coverage. However, relatively few people realize the even higher likelihood of incurring a serious disability during their working lifetime. Statistics can be developed by actuaries in many forms to increase this understanding and sales of voluntary products. This can be particularly effective in one-on-one work-site marketing situations.

Finally, a reinsurer can provide a risk-sharing arrangement that is customized to meet an insurer's needs. Some insurers may have a lower tolerance for risk than others. The increased volatility and higher expenses associated with voluntary products may not align with their corporate strategies. In some cases, voluntary products are only being sold defensively to round out their product portfolios. Reinsurance should be considered in these situations. A reinsurer can usually find a risk-share option to meet the needs of both parties. With group disability products, quota share, quota share with excess, and pure excess are the most common options available. There also are many variations of these options, some with profit-sharing components, available. The key when looking for a reinsurer, regardless of product type, is to find one that will provide the services based on your needs.

Mr. Andrew S. Niedzielski: I'd like to provide some insight into the role that reinsurers can play in a newer, less-established product offering in the group voluntary arena. To illustrate this role, I'll draw on our company's experience with a group carrier in developing a critical-illness insurance product for the voluntary market.

I'd like to start by reviewing the changes that have transpired in the group marketplace over the years. I believe the value of reinsurers has increased as a result of some of the changes that have transpired. First, in the past, the target market in the employer market was a relatively small group of highly compensated individuals. That has now evolved into a market where the target market is essentially the entire group of employees. As a result, the products now need to meet the needs of a more diverse work force. Historically, there was much more employer contribution to the benefits. Now employers are more reluctant to pay for the total cost of benefits. They prefer to sponsor benefits and have the employee foot the bill for the product offering. As a result, participation is no longer guaranteed, and, as you heard both Al and Scott discuss, participation rates are very important in the success of the product, in terms of the claim costs and loss ratios that you can expect to experience.

New products typically had their beginnings in the individual marketplace and then over time migrated to the group environment. More and more today, and particularly with critical illness, products may concurrently be introduced to a group market as well as an individual marketplace or, in fact, may have their genesis in the group marketplace. As a result, we may no longer have data that can be used to look at consumer acceptance of the product concept, claims development, and those types of things that we once could draw on from the experience of the individual marketplace.

One-year term products are now evolving into longer-term coverages and, with portability, the option to have renewable coverage for life. Obviously, the insurer is now on the hook for a much longer time frame. And, finally, the competitive environment has broadened over time with more nontraditional competitors entering the arena. As a result, there are more options for employees in terms of group offerings.

All these changes have added up to increased risk. I would suggest that if we looked at this same issue 10 years from now, we would continue to see a move to more risky product features in the group voluntary marketplace. I see this as an opportunity for reinsurance to provide tools, information, and resources to help the insurer gain comfort with this changing and increasing risk profile.

The tools and resources are similar to those discussed by Scott, so I won't focus too much on their details. But I do want to point out that the newness of a critical-illness product, and of new products in general, makes market research much more important and vital to the reinsurer. We need to determine whether the product can be viable in the marketplace before we take the leap into product development, pricing, and underwriting. I would also argue that these tools and resources can be equally important to large insurers as to small insurers.

The usefulness of reinsurance for large insurers can be more in terms of what I would call distraction protection. Large insurers may have the wherewithal and the resources internally to focus on a new product offering. By using reinsurance, it may allow them to take advantage of the expertise of the reinsurer while remaining focused on their core offerings so that those continue to provide the growth that the insurer is looking for. For small insurers, the reinsurer plays a more key role in terms of providing cost-effective resources. Due to limited resources, a small insurer may have gaps in specific levels of expertise and general resources that could be committed to a new potential product offering.

Before I get into the details of our arrangement with our group carrier to provide critical illness, I would like to lay a little foundation for those who may not be familiar with critical-illness insurance. Simply defined, it's an insurance coverage whose benefit trigger is the diagnosis of one of several specified covered illnesses, which are generally catastrophic in nature. For example, the trigger could be life-threatening cancer, stroke, heart attack—real illnesses that can have a real impact in someone's life.

Critical-illness insurance was originally introduced overseas about 10 years ago. It has been successful in places like South Africa, England, Australia, and Japan. In those areas where it's been successful, it has been primarily sold as an individual product through mortgage lenders and captive agents. In the U.S., there's been very little penetration in the market to date on either the individual or group side.

Long before we thought about approaching insurers about critical-illness reinsurance, we spent significant time and energy trying to determine consumer interest and need for this product. Again,

the marketplace was untested at this point. There was very little experience in the market with respect to critical illness products. We first wanted to find out if this was a product that would be considered valuable to consumers before we approached insurers to go through the product development process. We focused on a "bottom-up" approach, concentrating on conversations with consumers, employers, and brokers to determine their specific needs. Alternatively, we could have used international experience with some adjustment to put it in the context of a U.S. marketplace. Although we didn't want to ignore the characteristics of the international market, we didn't want to presume that everything that works in an international marketplace would work in the U.S. Some of the cultural differences, such as socialized medicine in some of these other marketplaces, are very different from the U.S. marketplace. We didn't want to make the mistake of assuming that U.S. consumers would behave the same way.

We performed primary and secondary research to address the consumer need. We conducted several focus groups throughout the country, hitting a variety of demographic groups varying by age, sex, income, and family status. We also interviewed employers, brokers, and insurers. We compiled a substantial amount of information that we thought was relevant and useful with respect to critical illness.

There are three key categories of findings that I want to touch on. One is the idea of market validation. We found a pervasive and almost all-encompassing interest and need for critical-illness coverage from consumers through the focus groups that we performed. This interest, desire, and need for the product spanned age, income status, and family status. It seemed to be a universal desire. Another important point in market validation was that consumers viewed this coverage as filling a gap in the existing insurance spectrum rather than duplicating existing coverage. A third point is that benefit consultants and employers felt that this was a worthwhile product to offer to their employees. Obviously, you need to get through the employer screen and have the employer feel that the product provides value before you can even have the consumer making a choice about purchasing the product.

In terms of product design, the two things we heard were to keep it simple and to give consumers control of the benefits. Al talked about simplicity in his comments, and this came through loud and clear in our research. The second finding is more specific to critical illness in that consumers wanted to be able to control the benefit. They wanted to determine if they had a critical illness and what they would pay for with the benefit proceeds, rather than having an insurance company determine what expenses related to that illness would and wouldn't be covered. They wanted to have control of their life.

They clearly preferred the employer channel for distributing products and found payroll deduction desirable as a convenient and less painful method of payment. We also found the need to provide the coverage on a voluntary basis, because employers were happy to provide the availability of critical-illness insurance but were not interested in paying for it. Our conclusions were that the product was indeed viable, and the group voluntary platform seemed to be a very good fit for this product in terms of selling and distributing.

Having confirmed the viability of the product, we were prepared to approach insurers to develop specific products to add to their portfolios. I will use our experience with one client to illustrate its entry into the voluntary critical-illness insurance marketplace. I won't go through the entire list of product design issues, but I'd like to highlight a couple of the points that were specifically related to critical illness and the results of the market research that we performed.

Regarding the covered illnesses, international policies started with about a half-dozen critical illnesses that would be covered. Over time, it evolved to the point of some companies offering in excess of 100 covered illnesses. Again, what we heard loud and clear was that the consumer wants to keep it simple. As a result, we talked to our client about having a limited set of five or six core benefits that would cover about 80–90% of critical illnesses to keep it simple and not confuse the consumer.

Another area where we wanted to tie in market research was in terms of the benefit payoff. Again, the consumers wanted the ability to spend funds as they saw fit. They wanted to determine which expenses they were going to cover, whether it was a shortfall in their health care coverage, transportation costs to get treatment in centers of excellence that may not be in their home state, or whatever. They wanted to be able to make that decision. As a result, we pursued a lump-sum benefit to be paid upon diagnosis. The consumer would determine what to do with the benefit. Theoretically, they could take it and have a nice vacation with it if they wanted to.

The last item has to do with survival periods. Some critical-illness policies may require that you have to survive a period of time following diagnosis in order to receive a benefit. For example, someone suffering a heart attack may have to live 30 days following the attack before the benefit will be paid. We saw this type of feature as cluttering the product without being of real underwriting or risk-selection value. We advised our client to remove this kind of feature in an effort to keep things simple and avoid employee complaints to the employer about the coverage being provided.

In traditional markets. there is a baseline of experience that you can draw from to develop pricing parameters. With critical–illness insurance, there is no experience to speak of in the U.S. This can become a real drain on insurer resources. We think reinsurance is a valuable tool to use in terms of this pricing process. There is data regarding U.S. population incidence, but it's not easy to find or broad enough to be able to use for pricing assumptions. This type of data needs many adjustments before it can be used in the pricing process. A reinsurer has the advantage of working with several clients and can invest the time needed because it will get used over and over again. An insurer may only go through this process once, which may not be a cost-effective use of its resources.

From population incidence, we need to get to insured-life incidence. Because this is a new market, there is no insured-life experience. As a result, we need to use a variety of estimation techniques to convert from population incidence to insured-life incidence. A popular method for critical illness is to compare mortality for specific causes of death between the insured population and the general population. It can get quite complicated.

Other considerations, such as illness definitions, need to be considered. Every definition isn't the same. Some definitions are more liberal than others. The specific definition is clearly going to have an impact on the data that you use and how you adjust that data.

As you've heard from both of our previous speakers, underwriting and high participation rates are critical to the success of a group voluntary product. The key is to balance the need for sufficient underwriting information to prevent antiselection against making the process so intrusive that the employee is discouraged from signing up for the coverage. Underwriting rules regarding the amount of benefits that can be purchased based on employee salary levels need to be developed. These may be quite different for critical-illness insurance than they are for other more traditional coverages, such as life insurance or disability income.

The process we went through with our client was definitely trial and error. We brainstormed and proposed underwriting criteria and got feedback from our client about how they felt their market would react to them. We then cycled back and made modifications until we were both comfortable that the balance between underwriting risk selection and presumed participation levels were at an adequate level.

An important aspect of critical illness is claims management. Declination rates for critical–illness insurance can be significantly higher than for other products. As a result, we pay particular attention to assisting our clients in setting up their claims processes and developing claims forms. We want them to have clear, concise, and consistent marketing materials, certificates, and issued policies. The materials should minimize the potential for disgruntled employees who submit claims that are turned down. Employer support for the product will die if a large group of employees become upset about claims administration.

Last, but not least, is risk transfer. Because critical illness is a new market with limited underwriting, there is considerable pricing uncertainty. That uncertainty is more related to frequency risk—the risk that the incidence rate is going to be wrong—than to random size fluctuation—the risk that one large claim is going to disrupt the results of the insurer. Because of the high reinsurer involvement in product development, pricing, underwriting, and all other aspects required to get a product to market, a quota share arrangement is probably the best reinsurance arrangement for both insurer and reinsurer.

In summary, we believe that reinsurance can be a valuable and efficient resource to help insurers enter the group voluntary market. This includes critical-illness products or any product that may come down the road in the group voluntary marketplace.

Mr. Stephen J. Rulis: I have a question for Andrew on critical-illness product development. From a direct writer's point of view, one of the things I'd want the reinsurer to help out with is portfolio management, that is, macro analysis of how products would coordinate with each other. For example, when you're paying out a lump-sum benefit to a given insured, what impact would it have on a person who might also be on LTD? Also, I was curious during your product development process whether you had considered the implications on LTD. Should there be any offsetting for somebody who's on, say, a monthly LTD claim of $5,000 a month and now also has $100,000 for critical illness? Are there any overinsurance issues to account for?

Mr. Niedzielski: We are not currently reinsuring disability coverage. From a selfish standpoint, we are less concerned with the impact of overinsurance on disability income. We have seen articles regarding the problems with a lump-sum benefit and how it may affect the disability product. It's a tough issue because, from our viewpoint, we don't see critical-illness insurance as an income replacement product. We see it as a lump-sum benefit that can be used to maintain normalcy in someone's life. When people develop a critical illness, they are going to have a number of unusual and additional expenses in their lives. We are trying to use that lump sum to cover those extraordinary expenses over a temporary period of time so that they can continue to have normalcy in their lives. In our focus groups we heard this a lot from consumers. One of the big fears was that the illness of a family member would prevent the family from being able to continue along the same lines that they were accustomed to. I don't know if I've completely answered your question. I know it is an issue that disability writers clearly need to be concerned about. I know that some lump-sum benefits can be significant. However, our particular view, which isn't the view of the marketplace overall, is that the amount of coverage that may be needed should be relatively small.

Mr. Wiley: I would also like to make one additional comment. The overinsurance question is similar to one I have heard in regard to activities of daily living (ADL) benefits sold on top of group disability coverage. You may have seen in the marketplace lately where companies may package a disability policy having a 60% replacement ratio with an additional ADL-based benefit having a 20% or 40% replacement ratio. In terms of income replacement, 80% or 100% replacement is definitely too much. However, when you consider how strict the ADL definition is, and the types of disabilities that will qualify, these disabilities will give rise to expenses that are not income-based and not incurred with a normal disability. The intent of this ADL-based benefit is to meet those expenses, not to increase the amount of normal income.

Mr. James T. O'Connor: In the group continuum from two-life groups through groups of 5,000 or more lives, there are, of course, special product considerations with regard to product design, underwriting, and marketing. I assume that most of your comments are directed at groups of 50 or more lives. What changes in product design, underwriting, and marketing do you think need to be made for small groups of under 50 lives, or even under 10 lives?

Mr. Niedzielski: This may be a feeble attempt at answering your question, but we're not targeting groups under 50 lives. We have discussed alternate forms of distribution such as Internet marketing that would be more on an individual basis. Underwriting clearly needs to be more stringent. It needs to look more like individual underwriting, and benefit amounts need to be limited. We talk about offering a very nominal lump-sum benefit, for example, for a critical illness in some of these alternate forms of distribution. The approach we take is to limit the benefit and try to do as much underwriting as we can, again, without doing so much underwriting that it's either too expensive or just draws poor risks.

Mr. Wiley: As far as disability is concerned, I would tend to agree with your comment. We don't see many cases below 50 lives, especially if you have a minimum participation level of 25 lives on your product. When you do go that low, you might want to restrict your plan design options by reducing the monthly benefit amount or shortening the maximum benefit duration. A stronger preexisting conditions clause or evidence of insurability could be required. Whatever you do, you will need to consider what the market will tolerate and what competitors are doing.

Mr. Niedzielski: I'd just like to expand on that point in another vein. Case size doesn't always indicate what type of products to sell. Large groups do not necessarily mean group products and individual products for small groups. I've had very large cases we were trying to sell group LTC to where the group approach did not make sense because there was no way that people were going to be brought to group meetings. In that case, we did not expect very high participation and felt it was better to sell individual and do one-on-one enrollments. Some individual marketers were asking why we would do that while others thought it was a good problem to have because you can probably enroll many lives very efficiently. Group size can sometimes mislead you into taking the wrong approach.

Ms. Donna R. Jarvis: This question is for Andrew. You said that on your critical-illness product you suggested that the client remove the survival period because it didn't add a lot of risk selection. I agree with that, but doesn't it affect the cost quite a bit?

Mr. Niedzielski: Sure, it does affect the price. For the kind of illnesses we've typically been involved with, the overall impact on rates has been somewhere in the neighborhood of 5%. However, while it does have an impact, it doesn't appear to be a very significant impact. Again, there is pretty limited data on this, and we could end up being wrong. One consideration, however, is

whether the survival period will save claims dollars. There may be legal issues associated with the survival period If, for example, a person survives 29 days under a product with a 30-day survival period. I expect that many lawyers would love the opportunity to challenge a claim denied on the basis of the survival period. Ultimately, I see survival periods disappearing. I'm not sure there will really be a savings to the insurer by having that survival period in there.

Mr. Paul D. Morrison: Andrew, the critical-illness benefit is a lump sum paid to a living person. Is it taxable in their hands and to what extent?

Mr. Niedzielski: My programmed response would be to please consult your tax advisor. We really don't know at this point. The jury seems to believe that, if the benefit is paid by the employee with after-tax dollars, then the lump-sum benefit would not be taxable, but I am not aware of any formal ruling on it at this point.

From the Floor: I have two questions. The first question is for Scott. In your presentation you mentioned that voluntary programs used to be for a select number of employees in the group plan. Now a larger portion of the employee group is highly compensated. Do you find definitions of disability being a concern, again, for total disability or for an own-occupation type of definition? The second question is for Andy. Regarding the group voluntary life, what issues do you see arising with regard to portability over conversion? We hear a lot about it, and I'd like to get your feedback as to what you are seeing in the marketplace.

Mr. Wiley: Regarding your first question, liberal definitions of disability are definitely a concern. To age 65, own-occupation coverage makes me nervous on a 100% employee-paid product. This is pretty standard on individual disability products. There is, I believe, a migration towards covering more highly compensated lives with voluntary products. Rates are cheaper than for individual disability, which may provide some of the attraction. These people are accustomed to getting extensive own-occupation benefits and whatever bells and whistles they want. That's not anything we're excited about covering with voluntary disability. We will need to address this issue at some point if this trend continues.

Mr. Niedzielski: With regard to portability, I've recently watched some focus groups, and it is clear that when employees buy their benefits, they expect to own them. Therefore, portability is very important. With respect to group disability products, benefits are usually connected to your paycheck; that's typically why it's not portable. When you get into other benefits, however, portability is much more important than conversion. Portability is expected.

CHART 1
WHAT IS VOLUNTARY?