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Session 6PD
"Once More unto the Breach": An Overview of the Disability Insurance Market

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Summary: For actuaries involved in the rapidly changing world of disability insurance, the 50th anniversary of the Society of Actuaries presents a valuable opportunity to reflect on the past, present, and future of the disability insurance market.

This session provides a comprehensive overview of today's disability insurance industry for group and individual disability insurers. Panelists address issues such as financial experience, mergers and acquisitions, changing products, the role of reinsurance, and growth potential. In addition, this session includes historical perspective on the disability insurance industry and a glimpse of what may lie ahead.

Mr. David E. Scarlett: I'm from Milliman & Robertson (M&R). I will introduce each panelist separately before he speaks. Chuck Meintel, our first speaker, is a group disability actuary with John Hewitt & Associates and is in charge of reinsurance pricing for both new and renewal clients. He's in charge of group consulting work and financial management of the group clients

Mr. Charles H. Meintel: I'm going to talk about only the group market, and the other two speakers are going to talk about the individual market. Basically, what I want to say is that the group market is one that has been challenging in the past, is challenging today, and tomorrow will be more challenging. I think you'll see by the end of my talk that we really haven't even begun all the change that's going to happen in the group market. I'm going to talk about three things: profitability of the market, where it's been, and what it is today. I'm going to talk about the top line and some of the marketing implications of the business. Then I'm going to talk

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

about trends—those trends happening today and those trends that are going to drive the change that's going to happen tomorrow.
Let me start with a quick history. The 1970s were when group long-term disability (LTD) began. The 1980s was a period of unprecedented growth—growth in terms of both sales and profits. Everything was in our favor in the 1980s. Interest rates were high. Inflation was high, causing people to want to get off claim. Employer growth was high. Employee growth was high. Young baby boomers were entering the marketplace. From a group perspective, the average ages of our groups were really declining during that period, which meant that as groups got younger and younger, the new entrants caused disability costs to actually go down. It was really the golden era of group LTD.

Unfortunately, all good things must come to an end. As the 1980s turned into the 1990s, that unprecedented growth and the trend of everybody wanting to jump on the bandwagon really turned into sales at all cost. Consequently, when the 1990s hit, we kind of hit the wall. I'm going to characterize the 1990s as basically a period of slow market growth, and you'll soon see some statistics about why I feel that way. I'm also going to talk about the intense competition that's out there and, in fact, some of the lunacy. Then I'm also going to talk about how, in spite of what might appear on the surface to be some good profit numbers, when you peel the layers of the onion away, things aren't always quite what they seem.

I'm not going to spend a lot of time talking about the forces that drove what happened in the early 1990s and really what's leading up to today. I could go into a little story about each one. Health care reform, for example, hit the group business in a couple of ways. As people exited the medical business, they looked for other sources of revenue, and those other sources, in a lot of cases, turned out to be group disability. Health care reform also hit from a claims perspective, relative to doctors and the health care segment, which is notorious for bad experience. Part of the problem, remember, was the fact that during the 1980s, we begged people to basically go out on claim. We sold them every bell and whistle that ever existed, and it's no wonder that the old saying "Be careful what you ask for; you might get it" came true in the 1990s.

Clearly, new disabilities and new attitudes towards disability—carpal tunnel, chronic fatigue, and AIDS—had huge growth in the 1990s. Although maybe at first blush there was an attempt to try to get disability claimants back to work and get rights for disability claimants, the new attitudes and the Americans with Disabilities Act had somewhat the opposite effect: disability was basically legitimized, so now being on claim wasn't quite the stigma that maybe it was back in the mid-1980s.

As for the changing business environment, recessions in the 1990s were now white-collar recessions. Mergers and acquisitions and layoffs were at the white-collar end of the spectrum. During the 1980s, traditionally, those phenomena did not affect the group business, or at least not the markets that we were in. Economically, interest rates were down, causing reserves obviously to climb. Inflation was down, so there was no erosion of purchasing power to force them to go back to work. (Going forward a little bit, I wonder how the wealth that's created by the huge rise in the stock market will affect termination rates, as people now have stock

portfolios again in our markets that are much larger today than they were in years past.) And, finally, there have been demographic changes. We see the slowing of employee growth and the slowing of salary increases; all those things during the 1980s were things that really drove profitability.

A few other trends relative to the group market pertain more to group LTD in particular, and some of these were successful. Some of them were not. Some of them are still obviously in a state of flux. I think the advent of choice and all the customization that occurs in today's group marketplace clearly is affecting the LTD and the LTD experience: integrated disability and things like 24-hour coverage. There are many, many people trying to implement those things and implement them well. We're all struggling with that one, probably as much as any. How is that to be done? How can we bring the medical, the short-term disability (STD), the workers' compensation, and the LTD all together in a nice integrated package?

Probably one of the most successful things that occurred in the 1990s was the concept of managed disability. Quite frankly, this is probably the new standard that companies in the group business really need to adhere to: the concepts of early intervention in claims and using rehabilitation nurses on claims staff. All the things geared toward managing a claimant back to work are really quite necessary in today's marketplace. Finally, what we're seeing is contract restructuring, which has to do with things like the self-reported limits and prudent person-type language—things in the contracts that are really geared toward helping companies do better claims risk management.

Chart 1 shows that in the early 1990s, profits were obscene; we couldn't contain our jubilation. By 1994, they had dropped significantly. The good news in this picture really has to do with the kinds of things that the industry did do in the short term to react to those declining profits, and I think this is actually good news for the industry from the perspective that it recognized the problem and reacted very quickly to it by redefining target markets. Companies wholesale would, say, exit the lawyer market or significantly curtail lawyers and doctors. The multiple contracts that had every bell and whistle that were available were now curtailed. Things like quality discounts came into being, rewarding people through price with better plan designs; those things were all in response to the declining profit in the early 1990s.

Renewals were another facet that really was nonexistent prior to the 1990s. Employer growth in the 1980s was characterized by the entrance of baby boomers. This growth caused the workforce to have a younger population. Therefore, no renewal in essence meant a renewal because of the declining average age of the group. In the 1990s that turned around, and now all of a sudden, with employee growth slowing and the aging of the baby boomers, you really had to start renewing your business; otherwise you were going to fall behind. Finally, I already mentioned that in the mid-90s period there was an increased focus on claims risk management—significant growth in claims staff.

The results were an increase in profitability over the next two or three years. However, there's still a lot of volatility in the profitability of LTD results (Chart 2).

The final number on the chart is 6.1%. That's the pre-tax statutory margin. These numbers come from the John Hewitt & Associates profit study that's undertaken every year for the group LTD and STD business. The corresponding GAAP number is 8.6%. After tax, the stat margin is around 4%, and again, that's the result of our survey. The equivalent GAAP margin that corresponds to that 4% is 8.6%.

On the surface people might think that's a terrific margin, but as Chart 3 shows, things are not always what they seem.

This chart takes the results of that profit survey and breaks them down among what I consider really the three businesses within LTD.

The first business (claims and expenses) is really your underwriting gain. If you think about it, in any given year you have your incurred premium for that year, and that's really like a whole separate set of businesses. You're going to experience claims on that in some fashion. Basically, in our study, the gain from that segment of the business was virtually nonexistent. In fact, I used 0.1% so that the bar would show up on the chart. The number is actually 0.

The middle bar basically is made up of three components: excess interest on your reserves, capital gains, and interest on surplus. You can see that even though the overall margin for the industry in 1998 was 8.6%, the majority of those earnings came from the nondisability-related function, if you will, in our business. I think that's a warning sign, going forward, that things may not be as rosy as they appear.

The last business, the -2.2%, is really the run-out of existing claims that you have on your books at the beginning of the year. Basically what that says is the reserves that we held at the beginning of the year were not sufficient to pay the paid claims and the reserves needed at the end of the year, and again, that's not a very healthy sign for our industry.

The second concept that also should provide words of caution has to do with when you switch from a margin perspective on the business to a return on either capital or equity.

Chart 4 shows the return either on statutory capital or GAAP equity. I'm going to digress for a second and be a little bit stringent on definitions, because I think this is a real problem in the group business. I define return on capital (ROC) as statutory gain divided by statutory capital. Return on equity (ROE), in contrast, is GAAP gain divided by GAAP equity.

When we called people to discuss their results from our survey, they would feel pretty good about their return. They would just say "ROE" or "ROC," but what we found was really happening was that people were taking GAAP gain and dividing it by statutory capital, and therefore significantly inflating their ROE numbers. That really is not the valid or proper way to look at it. The people who are really behind the eight ball take their GAAP gain, and they divide it by their statutory required or their actuarial required surplus, which is probably only about 60% of their statutory

capital. People would say, "We're getting an 18% ROC," when it was really not the total capital that was invested in their company and certainly not the equity that was invested in their company. I think we have to be careful going forward, and I recommend to everybody in the group business that they really look at their business in these ways, look at the returns that they're getting, and decide if they're really at the appropriate levels.

I'm going to switch gears now and talk about top-line growth. As far as sales go, again, John Hewitt does a survey on earned premium and sales twice a year.

Chart 5 is the result of the survey that shows that in 1998, LTD sales growth was 18%, clearly a reflection of the significant focus on large cases in the group market. Overall, the sales growth over the 1992-98 period was a compounded average growth rate (CAGR) of 13%. We're going to come back to this growth point. Keep in mind those growth numbers.

Chart 6 shows earned premium growth, and earned premium did not grow at the same significant rates as sales. I think that has a couple implications for our industry going forward. The first one is that an earned premium growth of 8% does not satisfy the tremendous appetite that's out there for growth in the disability business. If you go out and survey almost every group carrier on how much they want to grow their LTD business, every one of them will talk about a 12-15% top- and bottom-line growth. Clearly, 8% over this period is not 12–15%. Again, I think that in the future, that is going to provide some collision in the marketplace.

I think there are two reasons for this. We're not getting the employee growth or the salary inflation growth that, especially in the 1980s, helped the group disability market. The other reason is persistency. Persistency is down, probably since the mid-1980s to the late 1980s, depending on what year you look at it. Clearly, when you have $1 walking out the door and only $1 walking in the door, you've got to have a huge amount of sales in order to get that earned premium line to grow.

In terms of implications, I think you really have to question, Is there enough growth in the marketplace to satisfy the appetite of all the group carriers? Organic growth, like employee or salary growth (which is very profitable growth because, in essence, you're getting it with very little acquisition cost or very little antiselection), is nonexistent or very low. It really puts pressure on your persistency and your renewal strategies, which are all the more important as you try to manage your top-line growth.

Table 1 is simply a reflection of the organic growth, the salary and lives growth, that is way down now, as opposed to the early 1990s or the mid-1990s and certainly the 1980s.

TABLE 1
LTD CLIENT GROWTH RATE

	1995	1996	1997	1998
Employers	9%	7%	3.5%	4%
Employees	10	13	5.4	3.5
Slow "Organic Growth"				

Source: JHA Market Surveys

We've covered profitability and some of the things that got us to this point. What I want to talk about now in concluding are the characteristics of today's marketplace: irrational pricing, a loss-of-time focus, distribution concerns, and client confusion. Basically, the theme that you should walk away with is that these current trends are really what's going to drive the huge amount of change that's coming for the group LTD business

In terms of irrational pricing in the reinsurance business, we get to review a lot of the front-line underwriting decisions. We have seen people asking us to give 100% credibility on small 100-150 life cases. We have seen ranges of rates go from $0.12 to $0.28. We've seen significant use of pricing pools and discounting, basically all a function of the tremendous growth appetite in the business and people trying to figure out how to grow. I think accurate rating going forward is going to be critically important, and one of the issues that prevents us from doing that in the group market is the whole concept of self-accounting, which has been a mainstay in our business for many, many years.

I've said this before: I think that although the strategic decision to go self-accounting early on in the late 1970s and early 1980s showed genius at one end of the spectrum, today, at the other end of the spectrum, it appears to be an equally bad decision. Later I'm going to talk about the fact that group business is getting farther and farther away from the end customer, because the employees are now the ones making the decisions in terms of what they buy, and it's going to become more so in the future. I think that's something to keep in mind.

Another thing relative to the future is the concept of the loss-of-time market. This market is $340 billion, or 9% of payroll, where typically LTD might be 0.25% or 0.75% of payroll. Just like medical (which is probably around 20-25% of payroll), it influences the buying decision tremendously. This loss-of-time market is also going to play havoc with our LTD, because people are going to be focusing on this. What employers really care about in the service economy that we're in today is not so much LTD or not so much disability, but the productivity of the worker and having that worker at work. In a service economy, the employee is king. Therefore, the people who are serving that loss-of-time market will start becoming new entrants into the disability business. It's going to be interesting to see how that unfolds.

Will that market start becoming a source of LTD coverage versus the traditional markets or the traditional approaches that we use today?

I have already touched on distribution. We are getting in the group business farther and farther away from our customers, if you believe that employee choice is going to continue to be the method that goes forward. The other thing to keep in mind about distribution is that the new complex products that we have, the self-reported limits, and those kinds of things are creating tremendous confusion in the marketplace.

Table 2 shows the results of a survey that was done that asks brokers what kind of plan provisions employers valued. As you can see, with respect to mental, nervous, and drug and alcohol abuse, clearly a huge number of employers really accepted those limitations and understood them, but when you get down to the new things like self-reported and prudent person preexisting conditions, only about one-third of the employers really value that kind of product provision. What that says to me is that employers out there really don't understand what it is they're buying, and I think that's a danger in our business. There's obviously litigation potential as a result of that. There's confusion in the marketplace around that, and I think it's something we have to do a better job on.

TABLE 2
BROKERS' VIEWS OF HOW RECEPTIVE
EMPLOYERS ARE TO:

2 year Drug and Alcohol	83.5%
2 year Mental and Nervous	77.9
Mandatory Rehabilitation	51.7
"Prudent Person" Pre-existing	39.7
Self Reported/Subjective Limitations	35.1

Source: 1998 JHA Broker Survey

In summary, I think what we're going to see is that there are a lot of challenges in the LTD business. I think some of the fundamental structural things about our business—the way we account for it, the way we rate it—are really going to be tested as we go forward. I think the appetite for growth is going to cause all kinds of consolidation pressures. I think the loss-of-time market is going to really bring new competitors into our businesses. That movement toward choice is going to continue to be ever popular.

I think what you're going to see, if I put my real crystal ball out there, is that not too far down the road an insurance company will not necessarily be the gatekeeper of its entire disability portfolio. Unless we really solve some of the fundamental problems we have, I think what you might see is the insurance company doing the underwriting and the risk selection, with other third parties doing the selling, the premium collection, and the claims administration.

Mr. Scarlett: I will talk about the non-can individual disability insurance marketplace. Charts 7-9 have appeared in the Milliman & Robertson *Disability Newsletter*, based on the yearly research and article by Mark Seliber.

Chart 7 shows the in-force premium for the largest eight companies in the individual disability market. As I recall, these eight companies account for 60–70% of the in-force premium. In-force premium at the beginning of the 1980s started for these companies at about $395 million and grew to almost $2.7 billion by the end of the 1990s. The annual growth rate during the 1980s was phenomenal, at 1517% per year. When the companies started to increase prices, tighten underwriting, and tighten product provisions, the in-force premiums slowed their growth terrifically in the 1990s, and we actually had a 1.1% drop in the in-force premiums between 1997 and 1998.

Incurred claims have been the problem in this industry (see Chart 12). It started out in 1980 at 43.5% of premium—these are all percentages of premium—and it has been increasing steadily and reached an all-time high in 1998 of 108.3%.

Chart 9 shows the statutory profit of these eight companies. This is before dividends and before federal income tax. In 1980 profits were a very healthy 12.1% of premium, and it has been downhill since then, turning negative in 1986 and reaching a bottom of -15.3% in 1994. Earnings have turned around since 1994. The industry, on a statutory basis, only lost 4.5% of premium in 1998, but you remember that it's not incurred claims that have improved. The improved earnings are really from additional investment income and somewhat reduced commissions and expense.

With that as a brief history of the individual disability marketplace, I'd now like to introduce Gordon Dinsmore. Gordon is vice-president of Metropolitan Life Insurance Company and is in charge of all actuarial and financial work—in fact, all functions (except for marketing) for the individual disability business—as well as the small group business, up to 1,000 lives.

Mr. Gordon G. Dinsmore, Jr.: Dave asked me to talk about MetLife's perspective on the individual disability insurance (DI) market. I was flattered by that, because I think today marks my third month at MetLife, and so I'm looking at some people in the audience who have much better knowledge of MetLife's experience than I do. I guess it gives you an idea of how hard it was for Dave to find people at companies with a positive angle on the market.

MetLife is one of them. That, I think, rather than my three months of experience, explains my being up here. MetLife was a relatively minor player until recently in the individual DI market. It had very good experience. It's making money on its non-can business.

A few years back, the management switched over and started buying closed blocks of business from companies that were exiting. MetLife's DI business really was left in very good shape. At this point, MetLife is looking at expanding into some new distribution channels, some of which are natural things like New England's field

force, but also into brokerage sales, and that raises a number of issues. In any event, because of its block acquisition and the fact that it's one of the few players that's still positive on writing new business, I think Met has a unique view of the market.

I just want to talk a little bit about the consolidation in the industry to help put Met's position in perspective (Chart 9). Unfortunately, you can see here that I didn't compare notes with Dave, because I got the exact same numbers from Mark as Dave did. I just wanted to lead up to make the point that there's been a lot of financial trouble for individual DI writers. In particular, when the medical stuff broke in the 1990s, everybody's loss ratios became much worse on earnings, as Chart 9 shows. Finally, it's my belief, not necessarily for these eight companies but for the industry in general, that the real bottom hit in part because of reserve actions taken a few years after the medical market caused loss ratios to deteriorate.

In an M&R survey that was done for the DI symposium in Baltimore, the 57 DI insurers that were active in 1990 were surveyed. Only 23 were still active in 1998, and some of those 23, frankly, are niche players, so the picture about companies exiting the market may be even really more dramatic than those numbers indicate. The good thing, though, from our perspective about this, is that many of the companies that exit the business end up selling their block of business. Many already have. There's been an awful lot of activity during the last four years. It's possible the market will slow down because so many people have finally sold their blocks, but it's made for a very interesting business.

The other thing that's happened because of all the exiting and all the trouble in the business is that there has been a great deal of tightening in terms. I think, again borrowing from that same M&R survey, that the things that came out most dramatically for me were that lifetime had largely been dropped by most carriers, and that most carriers had added mental and nervous restrictions. In addition to that, obviously, prices are firmed, particularly for some short-earned premiums.

Chart 10 should just be financial statement data from the non-can line, and it just shows you that the business has gotten quite concentrated. Forty-four percent of the in-force premium goes with UNUM/Provident, and so on, companies at the top, with Northwestern second. The real point is again to reinforce the consolidation theme—that the business is consolidating into relatively fewer hands. Many of the 21% of "others" are probably companies that have exited the business and just have in-force premium. The ones, by the way, whose names I've given are still actively writing.

I thought I'd spend a little bit of time talking about block acquisition, in part because I've been at Met only three months, and I have more experience in block acquisition.

I guess the real key to success in block acquisition is having confidence in your own claim shop. If you don't have that, you're absolutely nowhere. You really have to believe that your claim shop is going to do a good job—at least as good a job as the

existing carrier and ideally better, or there's really no point in playing. It's not necessarily as hard to do as it might sound. After all, many of the companies that have exited the market—and they're the ones that are selling their blocks—will have lost some of their focus on the DI business. Many of the companies that have exited the business also follow the usual management procedure for expense management in this country, which is across-the-board cuts, and they tend to starve their claims department oddly at exactly the time they need to increase resources for their claims department. Often the across-the-board cuts get applied to the claims department, and if you see an opportunity where you're willing to spend money, whereas the company selling the block isn't, you can do quite a bit better. Finally, sometimes you'll find some people who are quite conservative, or a law department that's quite conservative, and see opportunities to improve.

Having said all that, you very much need to watch out for human nature. I really think that if you took ten claim shops or ten companies with claim shops, picked any one of them, and then asked the other nine claims managers whether they could improve on that one, regardless of which one you picked, you'd get at least three or four saying yes, they could improve. The problem is, that can't always be true. Your claims people, if they're confident (and that's what you need them to be), are always going to be able to improve on the blocks you're looking at. Yet you know that's not always the case, so when you're making the pricing decisions, you have to be very careful how to give credibility to their information.

Measurement is also very important when you're buying blocks. When you go in to buy the block, it's extremely important to take a large, well-distributed sample, keep careful notes on exactly how much improvement you can do and why, and go over that with the claims people before you do the pricing. Equally important, I think, is to track how much improvement you've really made after you've bought the block. That's not easy. Any exogenous event can disturb the pattern of claims incidence or termination and make it impossible to measure. Also, often, for the period before you owned the block, you're not going to get the data in the form you need to really measure accurately. Still, having said that, it's very important to measure the claims, because that's the key to the business.

On the actuarial aspects of trying to buy a block, interestingly, one of the main things you have to watch for ties back to Chart 9 and those reserve actions we saw around 1995. If the seller's reserve basis isn't about as good as yours, you're going to have a lot of trouble closing a deal. If you've got a somewhat impaired block and your own reserve standards indicate higher reserves than the seller's, it's very hard. Reserves are a use of capital, just the way risk-based capital (RBC) is, and it's quite expensive to have to add any significant amount of reserves. If the selling company wasn't planning to, their pricing and their inclination to sell just isn't going to be there at your price. You generally need to go in and look at the incurred but not reported claims and check that the termination rates in the first couple years have been refreshed—a very important point.

The other thing that's interesting when you're buying impaired blocks is that the relation of the risk capital you're imputing to the purchase, to the earnings, turns out to be very important. A lot of times when you're buying impaired DI blocks,

you're talking about blocks with essentially zero stat earnings or even possibly negative stat earnings; if you're going to impute a little bit of risk capital to a business, that works well when you're discounting a lot of earnings back at a risk rate (15%, 13%, or whatever). That takes the earnings back to a much more modest level, but if you're discounting zeroes, there's no cushion there, and you have to be very careful about what you're doing. It's interesting, because standard actuarial appraisal basically works off blocks with profits—and substantial profits, relative to the capital. When you go in and buy an impaired block, you need to be very careful.

The other thing that's dependent on what company is buying and selling is the view of how much RBC is tied up in the business. Since it's mostly C2 RBC, the two companies can have very different views, depending on their co-variance of how much capital is tied up there. I've given you a lot of warnings, but one good thing is that when you're writing a new non-can individual DI policy, it's very difficult to match the investment policy to the liability. The reason for that is obvious. The first year you don't have any money at all, and yet you've got a very long term liability you've just taken on, and you fixed the interest rate. That's the essence of its being a non-can policy. On an impaired block, you're going to buy midstream, quite often there are substantial reserves, the claims are starting to mount up relative to the premiums, and it is feasible to do asset/liability matching and to be pretty confident about the interest rate you use.

The last thing on this I'll talk about is structure. A lot of companies like to see assumption reinsurance rather than just an indemnity deal, where their name stays on when you buy a block. The problem with assumption is that it's very costly. You have to do a lot of mailings and a lot of systems changes, because you usually end up administering the block two different ways during the period when it's indemnity. It's very unlikely with a large block that you're ever going to get 100% agreement in all the various states that require positive approval by the policyholder, and some of the cost benefits of assumption just aren't there if you don't convert every single policyholder. Having said that, sellers like assumption, so you tend to have to offer it, but it strikes me as largely impractical.

I guess, having said that, I can no longer avoid talking about what we're doing with new business. With all the consolidation and trouble in the rest of the industry, Met's still out issuing new business. I guess the question is, What have we learned from everybody else's experience, if not from our own?

As I said before, Met has very good historical profits, and that's one of the reasons why we're still interested in playing. We have a relatively rich product. We still have a lifetime benefit, one that pays until you're well past 65—till you drop dead, in fact. We still have pure own occ, meaning own occ, and even if you're working at a different occupation, you can get paid. That's not available to everybody. It's a little more detailed than that. Met still doesn't have a mental and nervous exclusion. We're also not reinsuring at the moment.

Historically, the distribution for the MetLife business has been through its career force, and as a result, I think, the concentration ended up being quite favorable:

relatively few doctors, relatively less California business. The Florida business, oddly, was good. Finally, Met has traditionally had relatively low issue and participation limits. It wasn't out after the big policies.

Right now what we're doing is trying to expand channels, principally through brokerage, but also through New England, of course. That's forcing Met through a careful introspection, if you can call it that, on what it's doing with product. Really, if you look at the history here, the reason why Met had good results probably isn't because it had a conservatively designed product that made claims easy to fight off. Instead, it probably was sensible distribution, good pricing, and very good underwriting, particularly issue and participation.

As for a broader market, we need to go carefully, which means giving up on the distribution advantages we've had traditionally. We need to look very carefully at what we're doing on the product in reinsurance and issue and participation limits to make sure that we compensate for any extra risk we're taking on, and we'll be doing that over the next six months or so.

I just thought I'd throw in a couple of other things that I've seen by having looked at a number of blocks and having worked at a reinsurer. That business about issue and participation, I think, is far more important than people commonly realize. In the 1990s when things went wrong, the large policies suffered much more than the small ones. You can't look at a block without seeing that the reinsurer is being passed much bigger losses or a much bigger loss ratio than the direct writer. It was very disproportionate how badly the large policies did. Now, maybe that'll be different going forward if the next problem isn't doctors, but it's hard not to think that there's a lesson there, and that the very large policies we're issuing need to be handled with a lot of caution. There's a belief in the industry that employer-sponsored business has substantially better morbidity than individually issued policies, and MetLife is signing up for that theory and planning to put more emphasis on multilife.

Finally, one little thing that I think we're going to take a careful look at is rate regulation. In a lot of states, there's a 50% minimum loss ratio regulation. I think we've traditionally thought that if we write it up and file it in the various states, and they either don't make comment or make a few minor comments, we're home free with regulation. No matter how tricky our discounting was, we think that if the state doesn't have the equivalent of a Regulation 62 where you have to file regularly, we're home free and therefore can't be touched by customers or the plaintiff's bar for not having disgorged money earlier. I think we need to be careful about that point as an industry, because considering what's going on in the court system, I don't know if it's really true that your filing with an insurance department means that nobody can come after you later if you're actually running what they see as a 40% or 45% loss ratio.

Mr. Scarlett: I'd like to introduce Howell Palmer. Howell is senior vice-president, chief actuary, and chief financial officer of Berkshire Life Insurance Company.

Mr. Howell M. Palmer III: Let me just give you a little bit of background on Berkshire Life to put the disability business in a context and explain how we approach it. Berkshire is a mutual company. We've been around for a long time. We're domiciled in Massachusetts, but we do about a third of our business in New York. If you take New York and Massachusetts, it's about half of our company. That concentration is less so in the DI business, but generally it's pretty heavily concentrated in those areas. We're an individual company, life, DI, small pension plans, and annuities. We have six different distribution channels, but the primary channels that do most of the business are career and brokerage. DI brokerage has ebbed and flowed over the last 20 years but is now producing the vast majority of our DI that's through our general agencies, but is still brokerage business. But even though we have six channels, all of them focus on the same market. They're just six different ways to get to the same customer: small-business owner, professional, and affluent. Again, in the case of DI, that's primarily the small-business owner and the professionals.

Chart 11 shows where our premium income comes from. On the left is our total risk-bearing premium. This is just insurance. It does not include annuities. Our total business is almost three-quarters life insurance, and DI represents about 20% of our in-force premium. However, because of developments in the marketplace and opportunities that we've taken advantage of, our DI is, in terms of our new business, a little bit over half of our total new business, and the implications of that are perhaps obvious. The reason I'm showing you this is that DI has always been, even at 20%, a very important part of our company. We've been in the business for 45 years. Our senior management has always been very involved in the disability business. Our board of directors is extremely interested, and they've certainly asked us a lot of questions over the last five years about the transition from its being 20% of our business to 50% of our business, particularly in light of some of those graphs that you saw earlier. But I think the fact that the company and its management have been very focused on the business has been very helpful to us over the last 20 years or so. I think if you look at some of the companies that have exited the business, it has been in part because it was a minor part of the operation. It was not important to the company. You lost $20 million, big deal. In a gigantic company, that might not be a big deal, but n small company, that's a big deal. It has always been important to us, and I think that's been helpful.

Just to give you a couple of more numbers, and I'll be done with numbers, we have a block of about $50 million of premium (total premiums). It's not a gigantic block. We'll do about $11 million of new premium this year, $120 million of reserves. We had a profit last year of a little over $2.5 million. Over the last ten years, our Schedule H loss ratio has averaged about 61%; the previous ten years it was down in the 40s. We've had some pretty decent results over time.

I think some of our economic success has actually been as much about things we didn't do as things that we did do. We'll talk later about some of the things that we have done, but we've not had an overconcentration in the medical and dental business. This number has changed a little bit over time, but for the most part, three-quarters or more of our business has been small-business owners. Even though our product is very rich as compared with what's available in the

marketplace, we still have, for various reasons, been able to keep from getting an overconcentration in any one class or occupational specialty. We have always underwritten all of our business. We could debate whether this is good, bad, or otherwise. We don't have any guaranteed-issue programs and have never had any. We have no deep-discounting programs. I think when you look at a rich product, you need to be very careful about who you give it to and on what conditions.

We've focused on six areas in managing the block and have always felt that unless you manage all of these well, you're not going to be successful. We take an overall risk-management approach to the business, in spite of the fact that sometimes marketing people just want to drive the revenue line. I'm not going to spend much time on these, but clearly pricing is a critical issue. That's a key role that actuaries play, obviously. It's extremely important to be disciplined in your pricing and have good information to make pricing decisions on. Both underwriting and claims management are huge. I think we all know that. These have been areas where we feel we have some real core strengths, but it's very important to not only have those but also to feed them, to give them good information, to give them good tools.

Obviously, there have been a lot of problems with some of the product features that are out there. I'm not sure the blame lies entirely with product features as much as all these things put together, but certainly you'd like ideally to tailor the product features to the risks that the client has and its needs. Another area that's caused some difficulties is the issue of diversification, and this could be markets, specific occupations, or geographic concentration. I think the idea is that you need to diversify your liability portfolio as much as you diversify your asset portfolio to be successful. Again, some of the problems we've had as an industry have been associated with overconcentration in certain occupational groups.

I mentioned claims. In the last year, where there has been a lot of activity in distribution, we have moved from one or two channels to five or six channels. It is a challenge when you have different channels. What kind of morbidity experience are you going to get? We feel as though you have to focus on all these at the same time, and if you do any one of them badly, then you're in trouble, particularly if you've sold a product on which you can't change the price later.

What do we think about today? We're actually extremely bullish on the disability business. We think that the marketplace is very unusual if you look at the rest of the businesses that we're all in. Obviously, conditions have changed. It's a much more rational marketplace. Clearly, there have been a lot of competitors that have left. But the customer still needs what we have to sell. The conservatism that we've kind of kept all along in terms of our underwriting and claims practices is more accepted today. It's more in vogue, if you will. At least at the distributor level, they're not complaining about asking for information that now everyone else is asking for. As we grow our business, there are certainly some expense economies that will improve our bottom line, but all in all, we see this as an extremely unique opportunity for us, in that there are static or growing needs, fewer competitors, and improved opportunities for profitability. I'm not in any

other business like that. We're actually pretty excited to be in this business, but we do understand why some people have gotten out of it.

There are some disadvantages to growing, particularly if the growth is rapid. It's obviously a capital-intensive line, and any kind of rapid growth puts pressure on statutory results. We are a mutual company, and we focus primarily on that, as do the rating agencies. It's clearly a high-risk business and not for the faint of heart. Rating agencies do on occasion take a dim view of the DI business. While we don't run our company for the benefit of the rating agencies, we clearly have to be very conscious of their concerns, and rightfully so; they've challenged us (and a lot of other companies that are in the DI business) on why we're in it and if we know what we're doing.

There is, of course, a flip side. There are some advantages to growing our DI business. Done in the right way, it clearly has potential for profit. For us, it is a differentiator. We're also in the life insurance business, but so is everybody else. It's kind of hard, particularly for a smaller company, to differentiate yourself. We don't have a brand identity at the customer level. We have a brand identity at the producer level, and it's primarily, right now anyway, because of this product line. As we do grow our business, it does provide some support for our overall distribution expenses and allows us to strengthen the resources we have in some really key area, specifically, claims and underwriting. You've got to keep those areas growing if you're going to be successful.

GAAP results look different from statutory results, and while we're not publicly traded, we do look at GAAP numbers, and they do look quite different from stat numbers. As the business grows, capital requirements become somewhat lower. We can lower our unit expenses by obviously getting growth. And while we're concerned about rating agencies overall, the disability business is less rating sensitive. It's not insensitive, but rating is not as critical as it is in the large-case life insurance market, for example.

Over the long term, in order to be successful, of course, we have to be very careful about integrating a lot of the major areas of the company, particularly as we look to broaden our customer base and our product offerings; specifically, those areas would be underwriting and claims. As we have different channels, there are different kinds of marketplace needs for sales support.

There are a number of challenges, some of which have been identified. Obviously, there's a substantial concentration of business in the top four companies. There are also limited reinsurance options. We are not big enough to take on all this risk ourselves. We do have a reinsurance program, and there is not a huge number of reinsurers still in the business for the same reasons there aren't a lot of direct writers in the business. There are some opportunities, and we think that they're both at the producer level and at the carrier level. A lot of the producers, at least for the moment, are not happy about some of the things that are happening to their companies, and that's an opportunity for us, since we do brokerage business. There are a number of carriers that had agreements with some of the major

companies that are looking for products to sell. There are distribution opportunities.

There are some other issues as we look a little bit further down the line. These are both challenges today and challenges and opportunities in the future. One is the kind of continual change in the relationship between an employer and employee. That certainly affects group insurance, and it will affect, in similar ways, individual insurance. Telecommuting and home-based businesses, I think, are different kinds of issues, but very significant opportunities. There are something like 3 million home-based businesses in the country, and that number is growing very rapidly. The product we offer really doesn't work in that particular environment, but I think there are tremendous opportunities there for DI if you do it the right way. It is a claims-management challenge to try to figure out how to manage a claim on somebody who doesn't leave the house to go to work. A lot of the traditional claims-management techniques have to be revisited. I think that's a big opportunity from a distribution point of view.

Speaking of distribution, there are lots of ways to distribute any kind of product, and certainly in the disability area, a number of these are already active: workplace marketing; direct sales; bank sales; and the Internet, which will, without question, change the disability business. It's already affecting how everything is distributed, but it's certainly going to have an effect, and we'd better understand it before it runs us over.

There are some very specific actuarial issues in running the disability business. I think we've always had to be concerned about product elements. I think that we constantly need to be tying product or client needs to product offerings. You can get a mismatch there. You're either charging too much or too little. As we look at our pricing assumptions on the next product and the one after that, is the information that we have actually going to be useful? Take the Internet: if you were distributing disability through the Internet, what information would you get to price that product? That's an example of some of the things that I think will be a challenge.

Reserves have always been an issue. I think the adequacy of reserves will continue to be an issue, both on the new business and on our in-force business. That's not likely to go away.

I guess the last actuarial challenge is what I worry about more: trying to figure out what it is I'm not actually worrying about. What should I be thinking about that I'm not?

Here are some product trends. Increasingly we're seeing more customization at the client level—fewer embedded options, if you will. If you go back to products of five or ten years ago, although we didn't think of it as a package, we dumped everything into the product and calculated a price, and that's how much we charged. However, there are more product elements being pulled out and made available as riders. Figuring out how much to charge for some of these little pricing elements is a real challenge.

I think that increasingly, there's pricing flexibility put into the product. The industry, not too many years ago, was virtually all non-can. Clearly a move to guaranteed renewable is under way, and that, I think, is an improvement for the industry to be able to re-price products. A couple of different kinds of things are happening with product integration, certainly different ways you can integrate individual products with other kinds of DI, whether it's group insurance or social programs. We're beginning to see some combination products with DI built in linked in with a nondisability product, whether it's long-term care or life insurance. I think there are some opportunities to get additional sales, either of the DI product or the product that you link with DI.

I think that for at least a little bit longer, we'll have an ongoing debate about whether non-can is the root of all our problems or whether there's something else that we've been doing wrong as an industry. However guaranteed renewable is increasingly becoming part of what's in the marketplace.

As to what our next mistakes are going to be, obviously I don't know. I think we don't know what our next mistake is going to be, and we certainly didn't know what our last one was going to be. It could be almost anything. Obviously, we've had problems with certain occupations, and those occupations could change. Whatever we're chasing is probably the one thing that'll blow up in our faces. It could be product distribution, region, or occupation—I don't know what. I think the mistake embedded in all this is that we would assume that the world is going to be exactly like it is forever and that nothing will change, and that's probably the mistake. Not knowing what our next mistake is, what can we do about any of this?

I think first and foremost, you need to keep your liability risks diversified. How you do that depends on the business you're in, but getting overly focused on any one occupation or region is at least increasing the risk that you're going to have a problem down the road. I think there is already a movement, and I think it will increase to products with re-pricing mechanisms, whether that's guaranteed renewable, policies with dividends, or some other kind of nonguaranteed elements. Clearly, we have to continue to monitor the business that we're selling and monitor our in-force business for problems and trends. Actuaries certainly are well trained to do that.

Also, in the product development process, you need to get everybody involved. Our claims and underwriting and litigation people have always been very active in our product development processes. Sometimes we even let the marketing people get involved, but we don't let the marketing people pick the prices.

I think focusing on market share has proven to be a big mistake. Chasing premium is a really bad idea. While we've been successful over the last 20 years, we actually saw our new business drop off about 50% from 1987 to 1995. That was not a lot of fun to go through, but I think the things that we didn't do are why we're still here, why we're still in the business. I think you have to focus on the business in its entirety—on managing a risk portfolio—and not get overly carried away with chasing revenue or any other single element of the product.

In a nutshell, we think there are substantial opportunities in the disability business, but only under certain conditions. You have to do it the right way. There are critical skills here: underwriting, claims management, litigation management, and obviously actuaries, and it's helpful, at least in our case, for the company to be very focused. I know that's not necessarily possible in all environments, but DI is a big thing to us, and I think if we weren't focused, we would have been on the list of casualties long ago. Again, focus on risk management, not market share; I think there are more than enough things here for actuaries to do, and I think actuaries have to play a critical role in organizations in order for this product line to be run successfully.

Mr. Mark S. Seliber: Chuck, you raised an interesting point about the stock market. I would like to expand on that. You mentioned that with stock prices going up, perhaps people are accumulating significant wealth in the stock market. I assume you were implying that people might have more incentive to go out on disability and less incentive to return to work, if they have all this accumulated wealth. But then it could also go the other way. If the stock market has some significant corrections in the near future, which we haven't seen for a while, then that could also lead to a few extra stress-related claims.

Mr. Meintel: I think that's true. I guess my bias is that with all the money that's going into 401(k) plans (and that money has to go somewhere), I just think the market is going to continue to go up and generate good returns, at least until 2006 anyway.

Mr. Palmer: I think any time you make it more attractive or the circumstances make it more attractive for somebody to not work than to work, then you're bound to have problems. I put this in the category of what we are not worried about today. If the market keeps going up, then that could be a problem, but if it goes down like it did last week, then maybe we'll have different kinds of problems. Without trying to predict what's going to happen, you need to protect yourself with diversification, pricing flexibility, and refraining from over-insurance. (There's a tremendous correlation between over-insurance and claims elevation.) Those are only things you can control at issue. You can't control what happens to people's income, their occupation, or their wealth after issue, and people who have a lot of wealth coming into the process probably can't get any DI to begin with.

I think the people you're addressing are those who have accumulated rapid wealth. Yes, I think it's distinctly possible that could be a problem for disability insurers, but that's what the claims people are for—to make sure that claims are legitimate.

Mr. Dinsmore: MetLife's core business is largely to self-employed people, so there aren't all the stock options and 401(k) plans. I don't suppose we're worried about the upside of the stock market too much. As we go into multilife, though, it's a different matter, and we do need to look very carefully at the age of the group and how easy it is for them to retire.

Mr. Scarlett: Chuck, as I observe the group LTD market, I've drawn some parallels with the casualty market, where companies get very competitive in their

pricing. You talked about irrational pricing. Do you think that the group LTD companies have caused, through irrational pricing, some of the volatility that we've seen in the profits in the group LTD market?

Mr. Meintel: There's no question in my mind that if you go back to health care companies, with people exiting the medical market and looking for other sources of revenue, choosing the group LTD market is natural, if they already had group medical or group life. Those new entrants, coupled with the lack of employee growth and the lack of salary inflation, have caused profit problems. Obviously, increased competition is going to cause rates to go down. Certainly a fair amount of the growth in the 1980s came from salary inflation and number-of-lives growth, and that type of business and sale is basically a marginal sale. The only real cost you have on that sale is the claim cost. You don't have any of the distribution costs, or very little of the distribution costs, because they are already covered (or already had been covered in the initial sale). If you look at the typical loss ratio in the group business as being 60% or so, that's a huge part of your business having a huge profit margin, and that's gone, or virtually gone, because of the economics today. New entrants and the changing dynamics of the marketplace, I think, are the major reasons why things have become so volatile in the LTD business.

Mr. Steve M. Liou: Gordon, you mentioned the tightening up on claims-management practices. Have you seen an adverse impact towards lawsuit experience from recent tightening controls?

Mr. Dinsmore: For a lot of companies, tightening up claims management has been an evolution that's been going on for quite a number of years now, as the bad experience unfolded five or six years ago. Yes, you do see more litigation now than you did, say, in 1990. That's probably true of the whole country, of course, so I don't know how much it proves about DI. With regard to buying blocks, one of the things you look at is the litigated claims list, and if you have a sizable block and no litigated claims, it's an indication that the company probably wasn't very aggressive. You have to take them case by case, of course. And vice versa, if there is a lot of litigation, it may be too messy to get involved. I would say that as the industry has tightened and has denied more claims, certainly there has been more litigation over it.

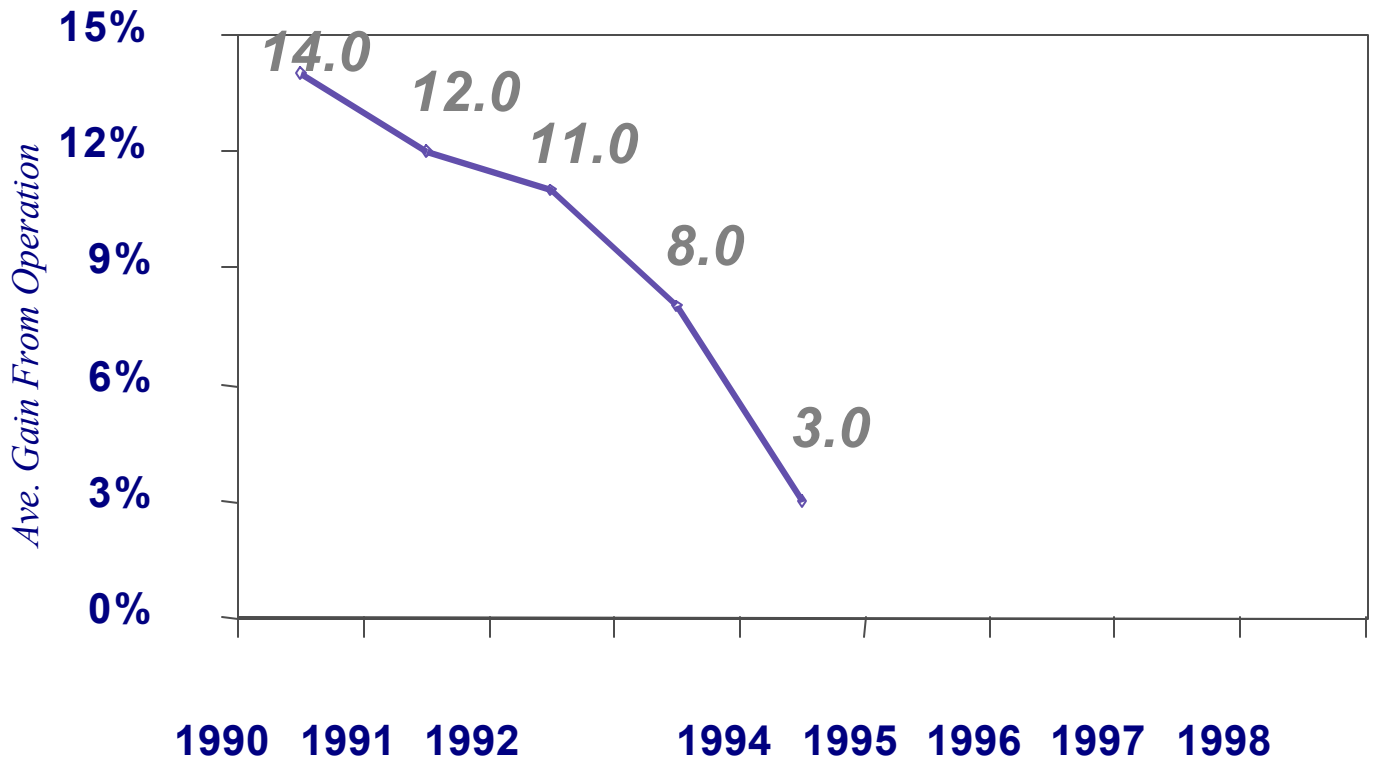
Mr. Palmer: Just to follow up on that, I think a couple things happen. As you change claims practices, particularly if they're more stringent, then you do increase the chances you're going to have litigation. Even if you don't change claims practices, the climate changes. Whether it's because you're in California or just because the general environment has changed or the numbers are getting bigger (the size of the benefits is getting bigger), the claims or litigation activity does increase. I think one of the things that you have to be willing to do is to litigate if you're going to be in this business. If you don't, then you're just going to get cleaned out. Whether you like it or not, there are people who will pick your pockets, and you have to have the stomach to do it. If you don't, then move on to another product line.

Mr. George M. Aghjayan: Dave and some of the other panelists commented on the statutory earnings from the M&R study and trying to draw some conclusions. Because of the slower growth in in-force premiums and the increase in the average age of the block, has any analysis been done that recognizes the age of the business?

It seems like the pattern of higher claims, lower commissions, and expenses as a percentage of premiums could be an indication of just slower growth, and the aging of a block would be a normal pattern that you would see. Has there been any analysis to adjust those patterns for the increasing age of a block of business that you would see from those eight companies?

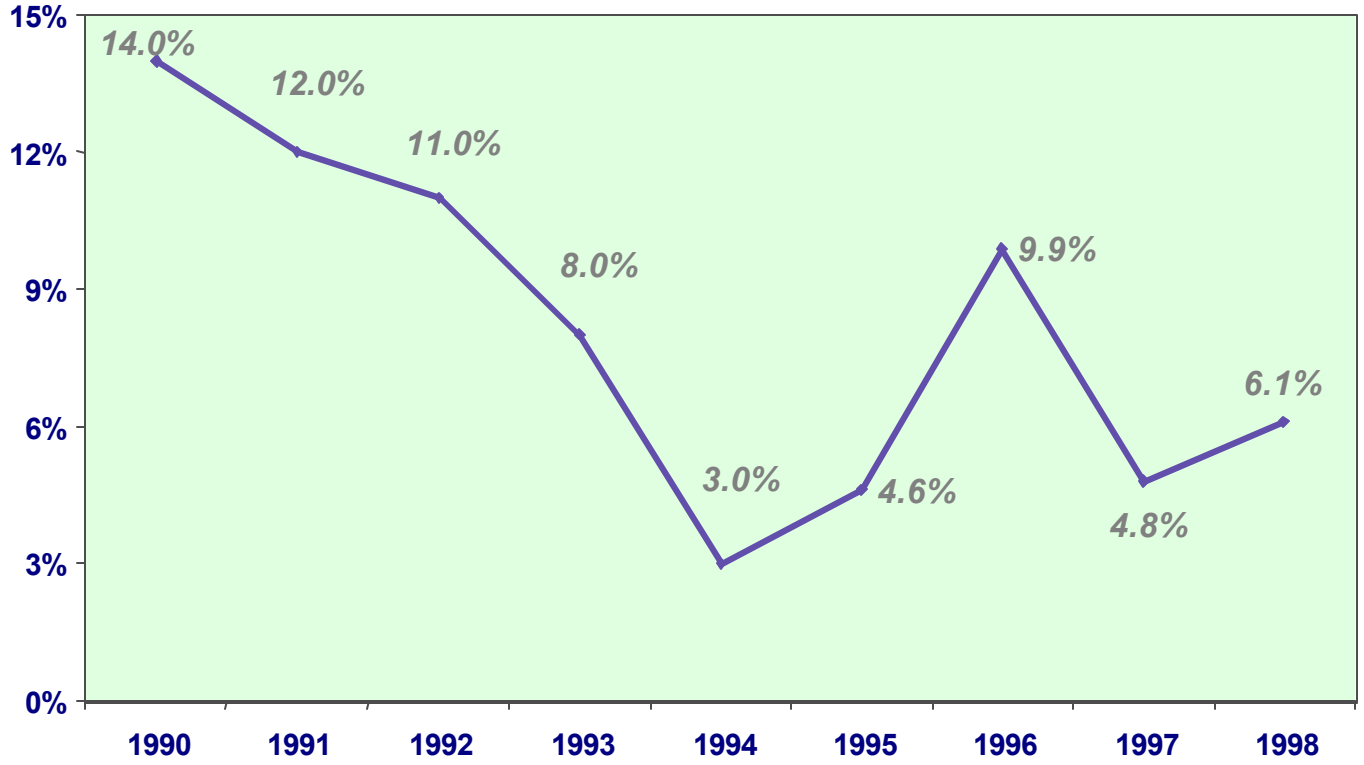
Mr. Scarlett: I think that's a very good observation. No, there has not been any analysis that I'm aware of that has tried to adjust for the age of the business. Ideally, what we should be showing are interest-adjusted loss ratios using active life reserves that approximate pricing assumptions. If we had that kind of a loss ratio in the analysis, I think the results would be age adjusted. Maybe that's something that we can ask Mark Seliber to add to his study in the future.

CHART 1
LTD PROFIT MARGIN
(PRE-TAX STATUTORY)



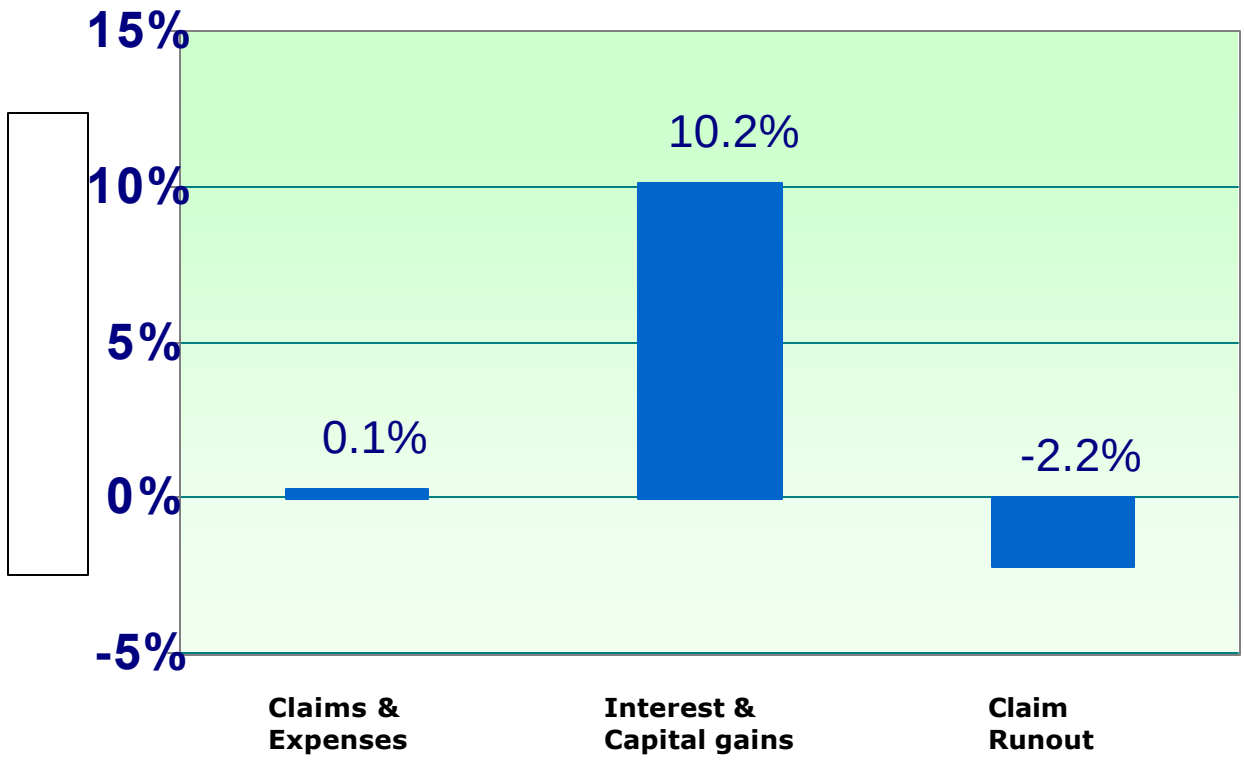
Source: JHA 1998 Profit Study

CHART 2
LTD PROFIT MARGIN VOLATILITY
(PRE-TAX STAT)
(AS PERCENTAGE OF PREMIUM)



Source: JHA 1998 Profit Study

CHART 3
SOURCES OF LTD GAAP PROFIT



Source: JHA 1998 Profit Study

CHART 4
STATUTORY RETURN ON CAPITAL/GAAP EQUITY

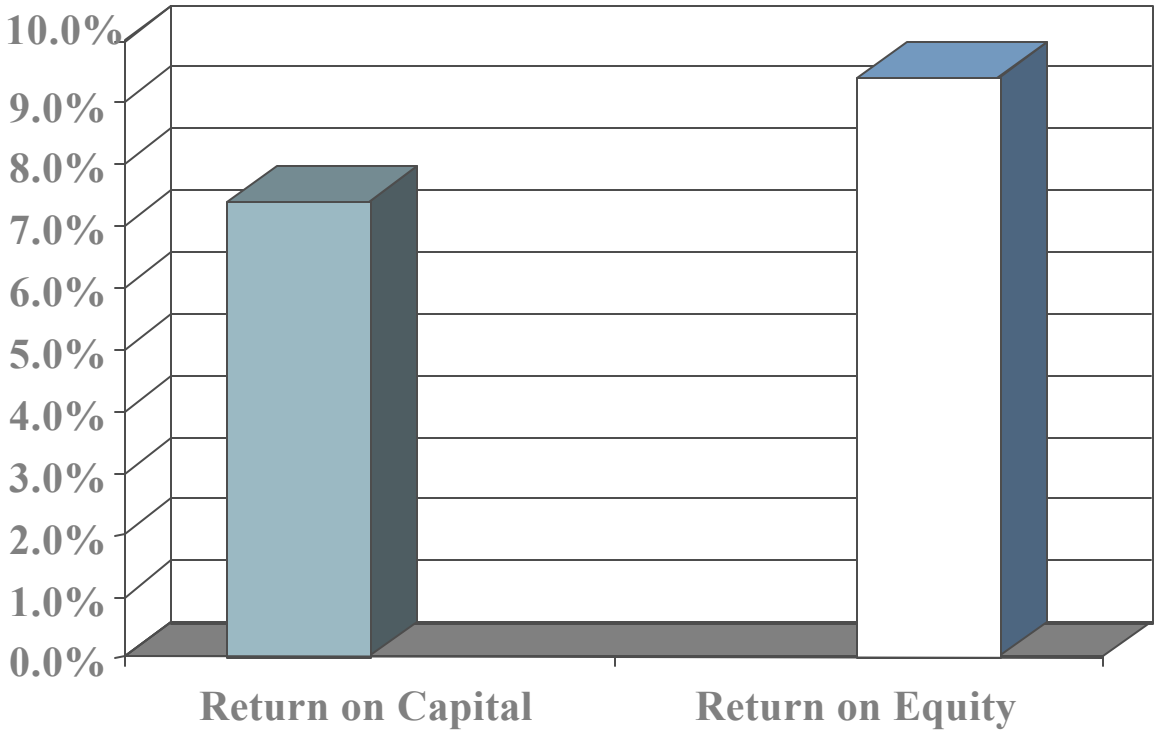
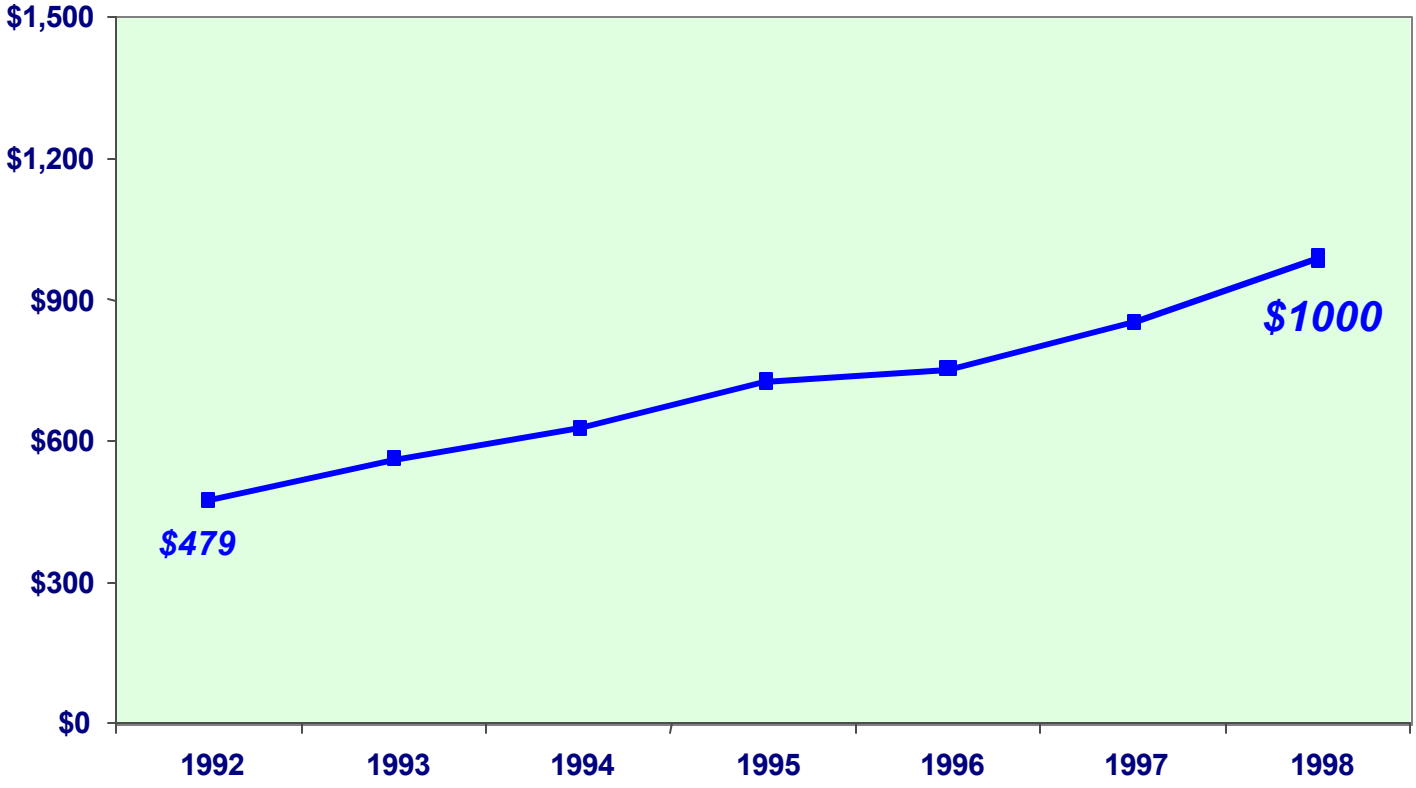


CHART 5
LTD SALES GROWTH
1992–1998

1998 Growth LTD 18%



13%CAGR

Source: JHA 1998 Market Study

CHART 6
LTD EARNED PREMIUM GROWTH
1992-1998

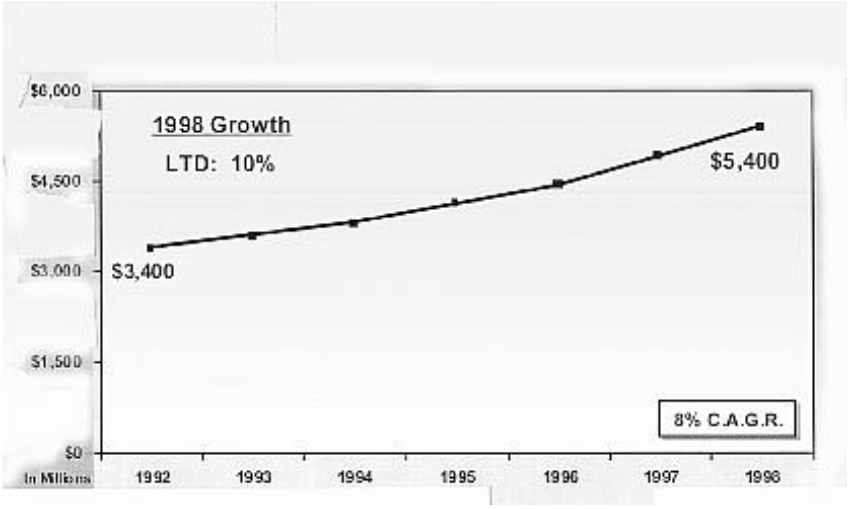


CHART 7
NON-CAN DI 8-COMPANY RESULTS
PREMIUMS AND GROWTH RATE

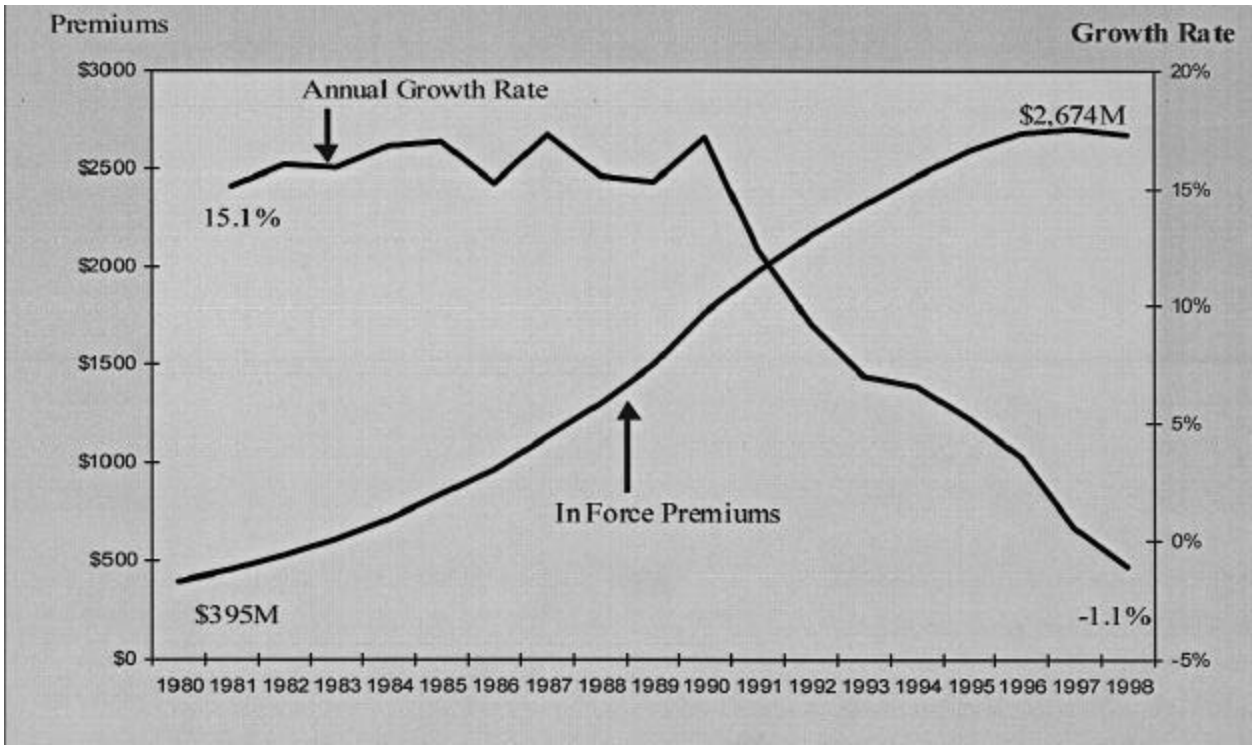


CHART 8
NON-CAN DI 8-COMPANY RESULTS
INCURRED CLAIMS

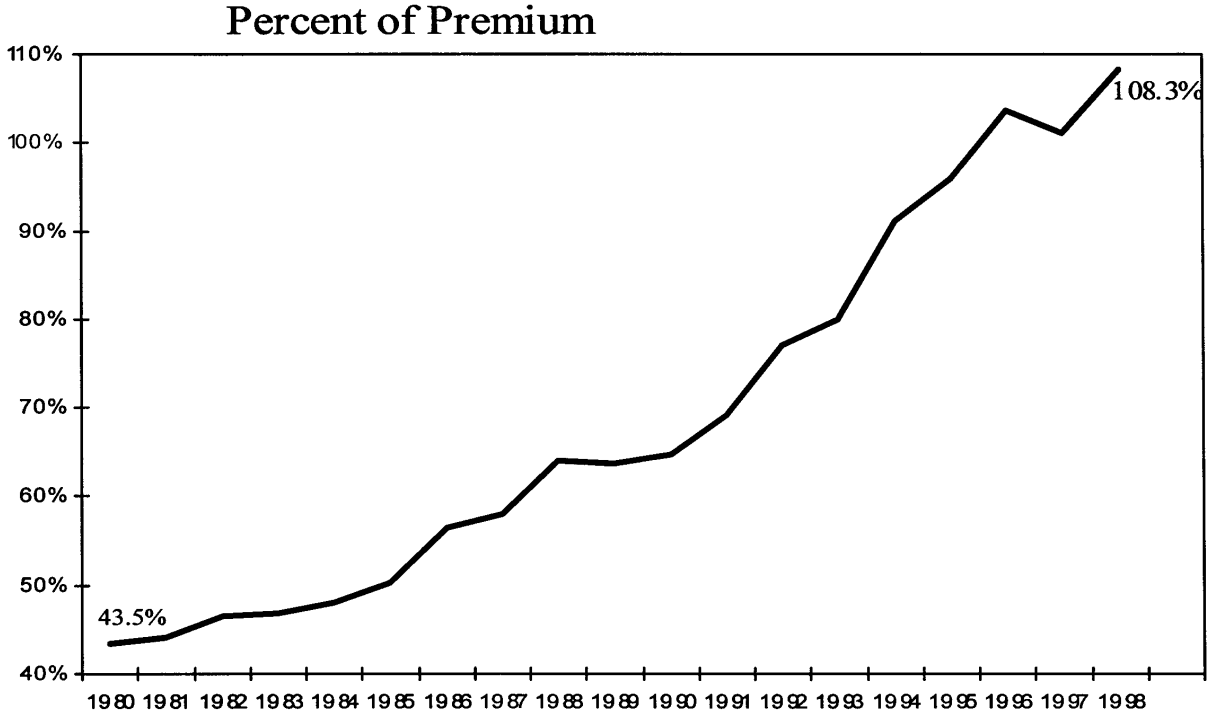


CHART 9
NON-CAN DI 8-COMPANY RESULTS
PROFIT BEFORE DIVIDENDS & FIT

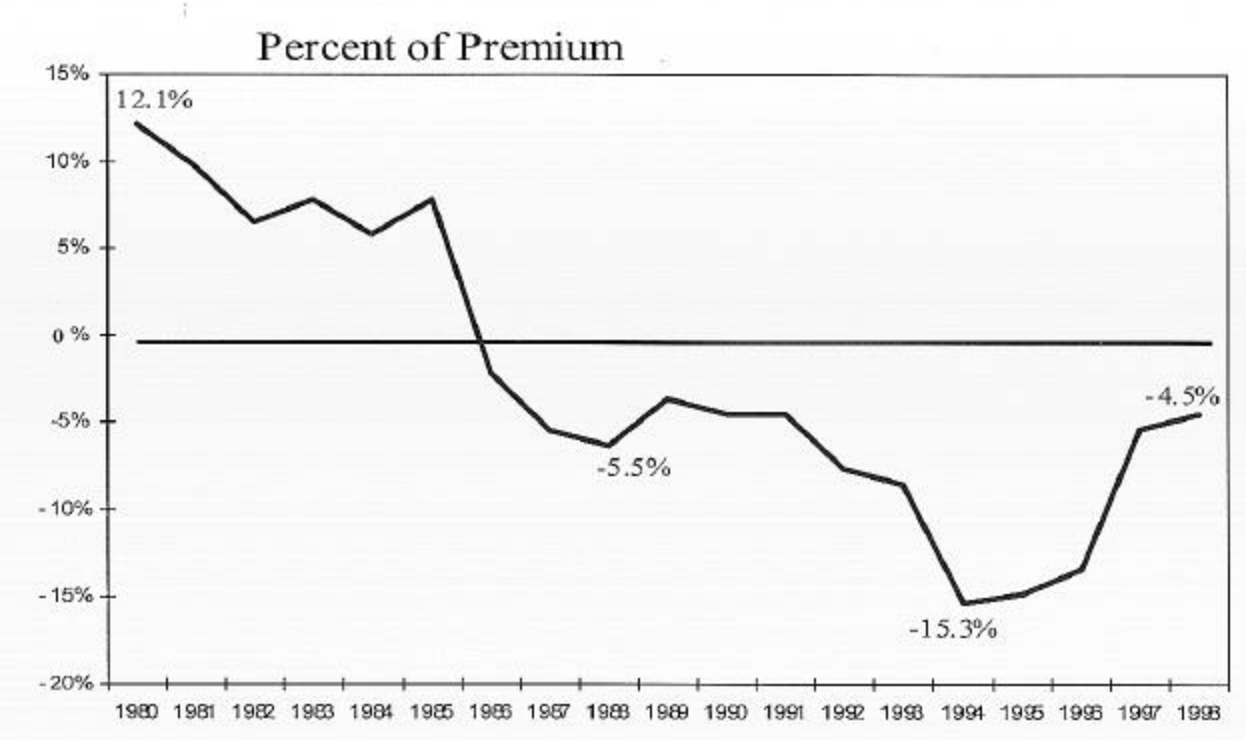


CHART 10
INDIVIDUAL DI CARRIERS
1998 INFORCE NON-CAN PREMIUMS
TOTAL $3.6 BILLION

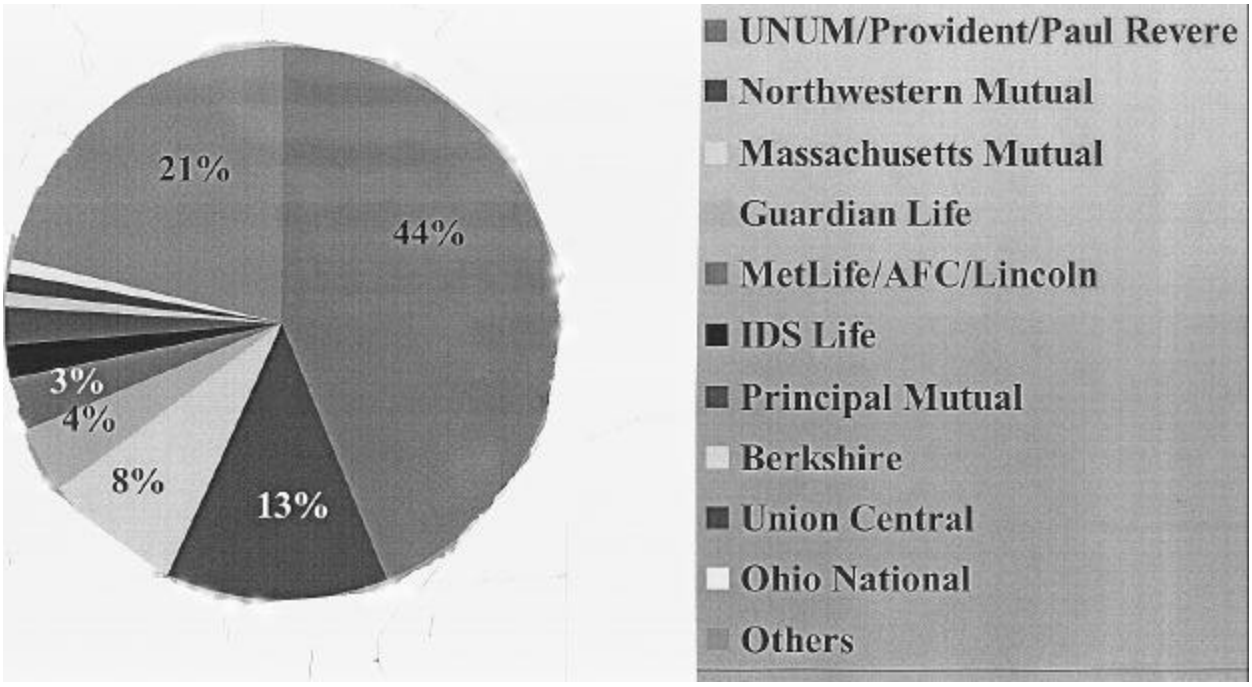


CHART 11
DISTRIBUTION OF 1998 PREMIUM INCOME