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Session 72PD
Managing the Overinsurance Risk for Disability Insurance

Track: Health Disability Income

Moderator: ANNE G. MITCHELL
Panelists: ANDRONICO LUCAS CASTILLO
HOWARD L. ROSEN
MARK D. SCHWISOW

Summary: The panelists in this session discuss a variety of issues related to overinsurance. There is a general introduction to the topic, followed by a more specific discussion of issues such as underwriting considerations, claim management and policy provisions. The relationship between reinsurance and morbidity is addressed, and panelists share the approaches used by their own companies in managing the overinsurance risk. Attendees gain an understanding of the overinsurance risk and the ways in which it can be managed.

MS. ANNE G. MITCHELL: Overinsurance, by definition, means too much insurance. But behind that definition is a wide range of thought on what overinsurance is. There are different ideas about how much is too much as well as the causes and the impacts of overinsurance.

We have three speakers here today; each brings a different perspective on overinsurance in the disability market. Our first speaker is Andy Castillo. He has been with Munich Re for 14 years and is responsible for reinsurance pricing and accounts management for both individual disability and long-term care. He is also responsible for the reinsurance underwriting and administration for long-term care.

Our second speaker is Howard Rosen. Howard is vice president and disability income product manager for Union Central. He is responsible for all aspects of Union Central's disability insurance (DI) line, including sales, underwriting, service, claims and actuarial functions. He was previously employed by Coopers and Lybrand and Conseco.

Our third speaker is Mark Schwisow. Mark has been with American Fidelity for almost a year now. He is responsible for their disability product and pricing in the

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

educational services division. Prior to joining American Fidelity he worked with several companies in the group insurance industry, most recently with Met and Fortis.

MR. ANDRONICO LUCAS CASTILLO: I will give a general perspective on the subject of overinsurance, and then I will discuss why it's an important issue today. Also, I will cover various items that impact overinsurance. In the latest edition of Charles E. Soule's book *Disability Income Insurance: The Unique Risk*, the author devotes an entire chapter to the subject of overinsurance. I guess from that perspective it is really an important subject.

Many of today's disability underwriting manuals also address overinsurance. In our *Munich Reinsurance Underwriting Manual*, we define overinsurance as follows: "Overinsurance arises when insurance is carried for a greater amount than insurable interest would justify."

If speculative intent accompanies overinsurance, then anti-selection is created. Overinsurance encourages fraud and malingering since a situation is created where there is insufficient financial incentive for the insured to issue more. The concept of insurable interest signifies that, when a person buys insurance, that person's relationship to the event or object being insured must be such that he or she would suffer a disadvantage from its loss.

Insurable interest in DI lies in the insured's well-being and economic stability, and it is evidence of the insured's continued ability to earn or to generate earned income. Why is the issue of overinsurance important? The underwriters I've talked with generally said that it's not a problem. It used to be. They said they have put in place various measures or controls to limit, or eliminate, the problem. Perhaps the problem is just that. They don't think it is a problem. That said, however, that they think it is a very timely subject, and let me tell you why I think so.

Earlier we heard a speaker talk about the increase in sales that we're currently experiencing in DI. A couple of weeks ago, I also attended the Health Insurance Association of America's Disability Officers Roundtable discussion in Quebec. And just last week I dialed in as a participant in the disability teleforum sponsored by Lehman Brothers, and I think some of you were in that teleforum as well. There seems to be a general feeling that a number of initiatives are already implemented in the areas of product design and marketing, underwriting and claims controls that effectively put in place adequate controls and financial discipline in the operations. As people become satisfied with the implementation of these initiatives, management's attention will now turn more toward growing the business again. After all, we need to pay for the cost that was incurred in setting up this infrastructure. Therefore, it looks like the consensus is that the DI industry is entering its growth phase.

As you may well be aware, the disability industry seems to go through cycles. There always seems to be a delicate balance between growth on one hand and profitability on the other. As we enter into a growth phase, as an industry we should remember the lessons that we have learned. One of the fundamental lessons to remember, as evident or elementary as it may sound, is that an increase in replacement ratios increases claim cost. It's fairly simple.

One of the articles on the topic, which you may want to review, is an article written by Bob Meilander and David Simbro, both from Northwestern Mutual, entitled "The Impact of Replacement Ratios," published in the June 1993 *Disability Newsletter*. In that article they referred to an SOA study that showed the relationship of claim rates in group long-term disability (LTD) experience to income replacement ratio. Generally this table shows that the lower the income replacement ratio, the lower the actual-to-expected claim ratios. The observation could be made that each 1 percent increase in the replacement ratio leads to roughly a 1 percent increase in claim rates. You can access these reports via the SOA Web site. I'm sure there are more up-to-date studies done by companies using their own data, but I believe the underlying message that this number shows would likely always remain true to a greater or lesser extent.

In that disability newsletter article, the authors also described a Menninger Foundation study that showed, by income replacement ratio, the probability of returning to work after five months of disability. The relationship is almost linear. But in the area of interest to most of us—that is, in the 50–100 percent income replacement range—a very rough rule of thumb is that for every five basis point increase in replacement ratio, the claim termination rates decrease by about three or four points.

What does this result suggest, and what is the potential impact on your replacement for claim costs? You can do the math based on your morbidity assumptions, but I did some rough calculations. I came up with increases in claim cost in the 7–10 percent range, assuming my interest replacement ratios increased by five points. Again, you may come up with different results based on your own data and judgment, but in essence we see the importance of the level of replacement ratios impacting claims experience.

I should mention that Meilander and Simbro, in their article that I just discussed, took some pains to point out that they were avoiding discussing the topic of overinsurance. Rather, they emphasized they were confining their discussion to the impact of increasing replacement ratios on claim cost. They were attempting to confine their discussion to something that is relatively more objective and more quantifiable. On the other hand, we all know that overinsurance is a subjective issue. We cannot avoid a discussion of replacement ratios when we are discussing overinsurance. Also, there is a particular level of replacement ratio that may be considered overinsurance by some, but not by others. They probably all see some maximum dollar amount of disability benefit from all sources that may be

considered overinsurance regardless of the person's salary or earnings. Currently, in the market, there is some pressure to push participation limits to higher amounts. How high is too high? I guess that's a question that we need to ponder.

Perhaps it would be interesting to design a survey where we could poll different segments of people in the disability field regarding what overinsurance is, in terms of replacement ratio and maximum benefits. I'm trying to put an objective measure to an otherwise very subjective topic.

Today there is also less stigma associated with being on disability. In fact, you may have heard the anecdote of a claimant overheard during a cocktail party boasting that he collects the benefits, but at the same time still earns a good amount of income from a lucrative contract. The person he was talking to became so envious that he reported these activities promptly to the insurance company. I guess that's not an urban legend—it's true.

The willingness to work is also related to the problem of overinsurance. Stress-related disorders are an increasing concern. The concept of motivational underwriting seems to be gaining ground. Motivational underwriting attempts to measure and assess an applicant's propensity to file a claim or continue out on claim. This is all done based on some set of tools or assessments at application time. Other sources of DI—Social Security, workers compensation, state cash sickness plans, LTD, salary continuance and so on—in fact increase income replacement ratios and, therefore, contribute to the problem of overinsurance.

Fixed contract provisions and fixed benefit amounts, combined with liberal benefits, do not allow us to react to the insured's changing circumstances and, therefore, limit our ability to control overinsurance. We also need to be careful about how we define insurable income in our contracts.

I have an example. This case was interesting from a number of angles. The insured was a successful, self-employed bulldozer operator who bought a $2,000 policy a few years ago. At the time he was earning about $70,000. At the time he bought the policy, he already owned a $1,000 insurance policy and another $500 policy from another insurance company. He therefore had total coverage of about $3,500—an income replacement ratio of 60 percent. So far that does not seem to present any problem. As years passed, he bought additional equipment for his business. As his business grew, he decided to incorporate, and he became an employee of his own firm. This allowed him to decide how much he would earn as salary and also allowed him to designate how much of the corporate income would be paid to him for the corporation's use of his equipment.

The policy's earned income definition seemed to be fairly typical. It included wages, salaries, commissions, bonuses, professional fees and other amounts received as compensation for personal services actually rendered. It excluded investment income and amounts received as a pension or retirement allowance. Rental income

is typically excluded as well, although his particular policy did not specifically exclude it.

The insured then became disabled from bilateral shoulder pain that severely limited his ability to do his work. He definitely was disabled. The issue that arose was when the insurer calculated his earned income prior to his disability. The reported W2 wage amounted to only $14,000. This being the case, the insurer then invoked the relation of earnings to insurance clause to reduce his benefits. The insured, however, contended through his lawyers that if one closely examined the insured's income tax returns and understood the nature of the corporate entity, his appropriate earned income should include the rental income, and when done that way, the relation of earnings to insurance clause had no bearing. Therefore, he should receive the full policy benefits.

This is an actual case and is still ongoing. The last I heard, the claims department of the insurance company had asked for the disabled claimant's most recent tax return. Apparently, the latest tax return still shows that he's making some rental income.

In determining insurable earned income, we need to look at net after-tax income, as well as nondiscretionary or nondisposable income. In Chart 1, we graphed each company's issue and participation (I&P) limits by gross annual income, and compared it against the net after-tax income. The nondiscretionary income was assumed to be at 60 percent of net after-tax income, and alternatively the nondiscretionary income was assumed to be 85 percent of net after-tax income.

We estimated the average deductions that would have been taken by individuals from their tax return to get the net after-tax income. Apparently, you can obtain the actual average deductions taken from the IRS. With the nondiscretionary curves that we developed, perhaps the 80 percent factor is more applicable at the lower income levels, and the 60 percent factor may be more applicable at the higher income levels. As I mentioned before, the subject of overinsurance is quite subjective. With this in mind, this graph seems to show that some companies at some income levels have relatively liberal I&P limits.

I should caution everyone about using this graph in actual practice. For more on the calculation you need to calculate net after-tax income that is more in line with your target market. I do not know if the IRS breaks down their data into finer cuts, such as by occupation, but it's probably worth exploring a little bit further.

Once you have calculated the net after-tax income, you then need to decide where to position your I&P limits in relation to the net after-tax income, and to what extent you're comfortable in replacing the nondisposable income upon disability, or the factors such as competition, your policy design and richness, your contract features and your target market. Underwriting and claims practice also come into play as you think about where to position your I&P limits. Another factor that can

have an impact on the problem of overinsurance occurs when an insured changes careers. The net worth of the insured and the amount of unearned income he or she receives also may have a bearing on potential overinsurance.

The existence of other specialty-type coverages that the insured has is also significant. In case you're not aware, there are specialty high-limit coverages over and above our current participation limits that are available through companies such as Lloyd's. Also, stacking coverages such as voluntary group LTD offerings, in which it is typical that the applications on these offerings do not ask for other coverage in force, provides the potential for overinsurance to take place.
A potential overinsurance situation can also occur in multilife cases, where, as an example, the case may start out as an employer-paid plan and, therefore, be allowed higher issue limits, but then change to a full employee-pay-all plan. There's a potential for overinsurance in that respect.

The next two examples I have are actual cases. The first one actually is from someone I know who got downsized but was lucky enough to find a position in another division of the same firm he works for. At the time he thought that he was going to be downsized, he applied for individual DI coverage. He was able to get an extra $2,000 on top of his $5,000 LTD. So in essence, he has a fairly rich replacement ratio. I think this case of overinsurance is probably attributable to the underwriter being asleep at the wheel.

The second case that I have is also an actual case. It involves a person I've known for quite some time who was a chief financial officer for a group physician practice. He told me a few months ago that they were looking into their benefits package and had their broker solicit bids. He said that they got a bid from a carrier who really wanted their business, and apparently they offered an additional 5 percent of income replacement to get the business. He told me he could not recall who the carrier was, but I think I'll probably remind myself to give him a call back and see if he can remember who it was.

MR. HOWARD L. ROSEN: Just so I have a point of reference, how many of your companies are in individual DI? Good. How many of your companies who are not in DI want to be in DI? And no hands go up.

First of all, let me give you a profile of Union Central. Union Central is a company that was established in 1867. It's not my fault, but it's a company that very few people have ever heard of. It is a mutual life insurance company, and the last time I looked we were the tenth largest mutual company by assets. That's kind of by default, because the companies above us seem to either convert to stock or combine. I guess if we wait long enough we might be in the top five.

We are, as a corporation, very focused on three target markets: the upwardly mobile, the independently wealthy and the small business owner. As far as the independently wealthy, they set themselves apart from the individual DI

marketplace, because they have sufficient assets to liquidate in time of disability. Typically if you're independently wealthy, and I'll get into what I mean by that in underwriting considerations, you're not going to be in the market for DI.

We distribute our DI product through multiple distribution channels. First of all, we grew up as a general agency company, so our core distribution is general agency, not a branch office in any way. We do have a couple of remnants of the branch office system, but we primarily distribute through a small entrepreneurial general agency system. Second, we distribute through what we call our DI centers. This is an owned or branch-type brokerage with a very modest model—a single DI manager, a brokerage manager and an office assistant. One of the things that we're doing right now is looking at expanding that model both horizontally with a rep increasing the ability to write out of a single agency, and increasing that vertically by getting more points of distribution. Finally, the last way that we distribute our DI product is by growing into a brokerage general agency system. We have multiple tentacles out there. The only way you can grow in this industry is to be able to grow through multiple distribution channels, because you have to think that when you deal with brokers, generally speaking, a broker selling your product is somebody else's general agent who couldn't get it with their own company.

Within Union Central, DI is an independent self-supporting line. Many years ago it was looked upon as an accommodation line. In the last several years we've changed that so that it has its own internal rate of return. It has its own income, revenue and expense alignment goals. Quite honestly, over the last few years, within the context of Union Central, it has been a very effective and successful line of business.

We've been in the individual DI business since 1966. But for about the first 25, actually almost 30, years, the company didn't make a nickel in individual DI. We lost money every year. In the early 1990s, the company did an introspective look, using outside consultants, at whether or not we should stay in the DI business. The questions that we asked ourselves were really should we stay in as a manufacturer and a distributor, which we were, as just one or the other, or should we pull the plug completely and get out of DI? We decided to stay in the business as both a manufacturer and a distributor, because we felt that we had the core competency to continue to grow the line successfully. As a result of that look, we took several actions in our DI business, to guard against the overinsurance issue. These were in direct response to concerns about overinsurance and some of the things that we saw in our actual experience.

We lowered our I&P limits. We stopped being in the business of writing $25,000–35,000 a month on professionals whose incomes conceptually justified it. Think about what you do when you offer somebody the opportunity to retire on $360,000 of DI benefits that are tax-free. We started requiring financial documentation. Up to a few years ago, not only did we, as well as many other companies in the business, not require financial documentation in order to write a DI case, but we even gave a

discount if you supplied it. We eliminated lifetime benefits. We, as did other companies in the business, wrote significant amounts of lifetime benefits as a rider on top of our existing base coverage.

If you think about individual DI, and you look at it as a coverage that protects earned income during the income-earning years, the concept of lifetime benefits is alien. We looked at that, and it was an easy decision. In the analysis that we do in our actuarial department, we can clearly discern a difference in loss ratios between policies with and without lifetime benefits. So it became a no-brainer to stop writing the rider.

On our inflation rider or cost-of-living adjustment (COLA), we lowered the maximum benefit and reduced the floor on increases. Why have a floor on the increase and benefits in pay status if you're in a noninflationary economy? Finally, we limited the availability of the residual rider, because of the potential overinsurance impact it could have on certain earners.

Now, having done that to our entire block, we looked forward as we designed new product forms and a new chassis. We do a lot of things now with respect to the overinsurance issue. We deal with it within the context of product structure. We deal with it in the underwriting department and in the claims department. Finally, and this may be somewhat counterintuitive also, we deal with it through our distribution department and the fact that we believe that DI is a relationship-based sale.

First of all, I'll talk about product structure. A lot of the things that we did were in direct response to an analysis of expected or actual policyholder behavior. With respect to a guaranteed insurability rider, which allows policyholders to increase their coverage periodically without any medical underwriting with just the benefit of financial underwriting, we limited the total amount of the options that one could take. We also limited each option, again reducing the opportunity for anti-selective behavior. Now, our rider is a little different than many riders that are out there. Some riders allow the options to be exercised every three years, sometimes with life-cycle events. Our rider can be exercised every year, but we do have the total limits, and we have the inside limits on the amount that can be exercised every year. The total amount that we will allow to be exercised is twice the original base amount issued, and the amount that we will allow to be exercised at each option date is half of the original amount issued. We also put a limit on the maximum exercise age, because again you get into certain types of anti-selective behavior increasing the benefit as much as possible in anticipation of a claim. We also use current financial underwriting requirements as opposed to underwriting requirements that were in place at the time that the policy was issued.

We link our COLA rider, which increases benefits that are in pay status as a result of the increase of some external index, to the Urban Consumer Price Index (CPI-U), as opposed to just the CPI, because we felt that that was a logical link to the

expenses that occur during the life of a claim. We changed from a higher maximum amount and a floor to a 6 percent maximum amount and a 0 percent floor. Even now there are some riders out there that have a floor of 1, 2 or 3 percent. Why increase a benefit in pay status if you're in a noninflationary economy?

We looked at our social insurance supplement rider also. This is a rider that is added on to the base coverage and will pay if social programs do not pay. We changed the structure of the rider to a dollar-for-dollar offset with federal, state and local disability programs. We felt that resulted in a direct correlation between benefits received or not received from government programs. Also, the rider will not pay if the insured is otherwise gainfully employed. If the claimant is somehow collecting a government benefit, but is otherwise gainfully employed, the rider will not pay.

I'll next address the definition of disability. Our prior product series was kind of a one-size-fits-all type of product. If you had an occupation of X, this is the contract and the definition that we offered. In the white-collar market, which is where Union Central sells, that generally meant a long-term own-occupation definition. Well, if you have it there and you're going to sell it, somebody is going to buy it. People who understand the coverage, in many cases, are going to buy it, because they may have the opportunity to use it and double dip. With our current series, we offer up to six definitions of disability. And while we still offer a pure own-occupation definition, we try to limit it with respect to certain occupations and especially ages within occupations.

We do have a relation of benefits to earnings rider. It was filed and approved in every state. We do not use it. We have found in our claims analysis that this type of overinsurance has not been a problem for us. It's good that we have it in reserve so that if we start seeing some measure of abuse and want to guard for it within the context of new business, we can do that. The other issue that we found is that none of our competition seems to have it either. You can cut off your nose to spite your face by putting a limitation that the field of competition is going to exploit when they compare your policy, as they certainly will.

Now, lastly on product structure, this is an idea that is on our drawing board. It's a little complex, and I believe one other company may have it. It's a conditionally renewable rider, and it's used only in the context of employer-paid cases. If you look at issue and participation limits and the implicit replacement ratios that result from those I&P limits, certainly you know that the amount of business that companies will issue in an employee-paid situation is less than that which they will issue in an employer-paid situation. This is because if the business is employer-paid, the benefits are taxable. But if you look at the after-tax replacement ratios that result from a typical company's employer-paid versus employee-paid replacement ratios, what you'll find is that after-tax ratios in the employer-paid side are lower than the after-tax ratios in the employee-paid side of the house. Part of the reason behind that is there is a concern, and I think Andy touched on it, that

the payor status of employer-paid benefits could change. So if you have a high benefit amount that is correct on an after-tax basis for an employer-paid situation, if that employee leaves the employ of the company but is offered the option of continuing the policy by paying the premium out of their own funds, the individual will probably take the policy, because older policies are valuable. But all of a sudden the replacement ratio changes, because the tax status of the benefits change. So there is a certain amount of concern about that.

Suppose for that corridor between the employee-paid after-tax replacement ratio and the equivalent employer-paid after-tax replacement ratio, you added a conditionally renewable rider that makes up the difference so that the replacement ratios are the same. If the payor status of the policy changes, that's a condition necessary for the rider to terminate. Now all of a sudden you're back where you were before you had the extra coverage. So this is on our drawing board. We've actually floated this as a trial balloon to several insurance departments. We found that some of those insurance departments grabbed onto it and understood. The factor to cause us concern is that most of the insurance departments gave responses that clearly demonstrated that they didn't have a clue what was going on. And that is a real concern.

Now I'm going to discuss underwriting and the use of financials. I mentioned the fact that we now require financials on all of our individually issued business. We look very carefully at other insurance in force. We want to look at all sources of insurance, whether it's insured or self-insured. Now, what do I mean by that? I mean unearned income. We reduce our issue and participation limits by one-half of the monthly unearned income in excess of $20,000 a year. Why? Because if an individual has a stream of unearned income that will flow whether or not that individual is disabled, there is a reduction of the incentive to return to work. Closely associated with that, we'll look at net worth, and we'll look at the liquidity of that net worth. It's one thing if an individual has high net worth as a result of owning three office buildings that are highly illiquid. It's another thing if that individual has $4 million dollars of liquid assets that can be turned into an income stream.

I'd like to go into more detail about I&P limits. Any time you talk about DI experience, the replacement ratio is the key. The replacement ratios that result from our I&P tables vary by income level. They vary between employee and employer payor. They vary between with and without LTD, and we also have lower issue limits in the medical market. Now let's see what those mean in actual practice.

I built Table 1 from our I&P tables. As you can see, this table demonstrates all of the points that I just made. You can see that the maximum replacement ratios are different between employee- and employer-pay. Those replacement ratios decline as income increases primarily because, as income increases, discretionary income increases. They change between group and individual. You can see that, as income goes up, in every case replacement ratios go down.

Table 1

Underwriting

- Maximum Replacement Ratios

Earned Income	Individual Only Employee Pay	Individual Only Employer Pay	Group/Individual Employee Pay	Group/Individual Employer Pay
$ 50,000	69%	80%	71%	82%
100,000	58%	71%	62%	75%
150,000	49%	62%	62%	75%
200,000	45%	57%	61%	75%
250,000	40%	50%	59%	72%
300,000	37%	47%	58%	70%

Next, I'll talk about claims administration. How can you prevent overinsurance in claims administration? Well, the magic is in the two-year contestable period. We do consider the duties and sources of income at the time of claim. We consider all the duties and all of the earned income at time of claim. So you may have a physician who owns two or three individual practices but has his own practice as well. He's deriving income from sources of ownership and management as well as from his individual practice. If that individual became disabled but shifted his time and emphasis between the individual practice and managing the other practices, but after the physical loss had the same or more income as before, you have no claim. There may be a physical disability, but there is no loss of income, and so you have to look at that very carefully. Again, the important point is a review of contestable claims.

Now, our field wants us to show that we are easier and easier to do business with. Don't keep asking for medical documentation. Don't ask for all the tax returns. Now, what does that mean? Sometimes it means that the information that we get during the underwriting process is not of the highest quality. At the same time, at the time of claim, that same field associate is going to say, "My client is disabled, so please don't hassle him about tax returns and medical, and all that other stuff that you have the right to." Well, you know what? It is our contractual right. It's in the contract for a reason, and we take advantage of that. We take advantage of that not to look for ways of not paying claims, but to look for ways of paying claims

that are appropriate. We have found some very strange things. I have an example case that I want to use.

We had an insured who applied for and received a DI policy in 1998. Within two years, the insured had incurred a claim. During the claim adjudication, we requested actual tax returns, and we got the approval to go to the IRS and get copies of actual tax returns for the years 1996–99. Now again, we're in the contestable period. When we looked back at the underwriting file, because we were trying to be easier to do business with on the sales end, we found some really interesting stuff in the documentation that the insured submitted. It appeared as if in 1998 his income was $102,000; in 1997 it was $80,000; and in 1996 it was $100,000, fairly steady—maybe there was some bonus income that went up and down. When we looked at the tax returns obtained during the contestable review, we saw that in 1998 there was actually a business loss. In 1997 the income was $34,000, and in 1996 the income was close to what he disclosed. But based on the information that we obtained during the contestable review we denied the claim, rescinded the policy, and refunded the premium. While this may be termed underwriting at the time of claim, this is truly a form of guarding against overinsurance.

Finally, I mentioned that it is possible to work through your distribution channels and guard against overinsurance. But the key in this particular situation is that you have to have a relationship-based sales mechanism. The people who sell your policies are the front line of defense against overinsurance. So if you believe as we do that DI is a relationship-based sale, not only should the producer have a relationship with the insured, and be able to evaluate whether or not the information supplied during the underwriting process is accurate and fair, but the company should also have a relationship with that producer, so that the producer feels a sense of loyalty in working for not only the best interests of his or her client, but also the company that the producer represents. We truly feel that DI has to be a relationship-based sale with a real person sitting eyeball to eyeball with the insured, and that person must have a strong relationship with the company.

While we are doing all these things, as are most of our competition, the key to the continuation of individual DI marching back toward a consistent level of profitability is making sure that we don't repeat the sins of the past, and guarding against overinsurance is, we hope, the way that we can do that.

MR. MARK D. SCHWISOW: As an anecdote, a few years ago I was with another company. We did some focus groups on voluntary disability, on a group platform, and went out and solicited input from three groups of people: (1) the brokers, (2) the employers and (3) the employees themselves. The employees were the most interesting of the three groups, because what we learned from them is an appropriate disability plan should pay benefits starting at the first day of disability for life, covering 100 percent of predisability earnings, should pay your medical bills and should also be dirt cheap. Overinsurance, I guess, is in the eye of the beholder.

With that, let me give you a little bit of background about my company. I have been with American Fidelity for about nine months. It's a medium-sized insurance company based in Oklahoma City. Our primary distribution arm is a captive sales force; we compensate them via a base salary and a sales bonus. The initial sale that we make is to the employer, and that gives us an entrée into the group to do work-site sales to all of the employees in the group.

Our main product offerings are DI, cancer, annuities and a little bit of supplemental medical business. We do not sell any sort of comprehensive PPO- or HMO-type medical plans. We do sell a little bit of life insurance, on both a group and an individual platform. About seven or eight years ago, American Fidelity decided to have a separate division to focus on the educational market including school groups, colleges, universities, education associations. I am now the pricing actuary for that group.

Since we're in the education market, with the exception of the support staff such as bus drivers, cafeteria workers and custodians, most of our insureds are well educated. They're white-collar employees. Salaries are moderate; average income for educators is about $43,000 per year. We have very few monthly indemnities that would range above $5,000 just because, with the exception of a few principals and superintendents, there just aren't that many high earners within the education field. Unlike Howard, we don't worry too much about net worth. My wife actually works in education, and she tells me there aren't too many independently wealthy teachers out there.

As far as the product goes, we're unique in the industry. Most of the business is sold with very short elimination periods. Fifteen days or fewer is the norm, and we have a lot of first-day accident business on the books. Some of the business is short duration—typically a traditional six-month benefit plan—but a lot of it will go to age 65. It's sold in $100 increments. What this means is while we typically sell a 60 percent plan, in reality most people aren't going to be getting 60 percent; they'll be getting 55 percent, 58 percent, just because the math works out that way.

Below a certain benefit level, we're selling not subject to insurability. We have a few knock-out questions. If you have a dread disease, or a few very specific diagnoses, we're not going to insure you. Beyond that, if you want higher amounts, you're going to have to supply insurability information. If you do go into underwriting and you don't pass, we will still issue you the not-subject-to-underwriting amount, and we will apply preexisting conditions and limitations as appropriate.

As far as the benefits go, we offset against Social Security and workers compensation. We also have the teacher retirement systems, which are a major offset for us. This comes up in virtually all states, and it does vary by state. I'm not sure if any of you are aware of the plans. They are all unique. Most of these benefits are not subject to federal income tax because they are sold with posttax dollars, out of the employee's pocket. We do have a little bit of Section 125

business—that would be an exception where it would be a taxable benefit. With very few exceptions, all of our cases are sold on a list-bill basis. We will, on a monthly basis, issue a premium statement, and the districts have to go through and do the traditional adds and drops and things of that sort.

Our field force is compensated on new sales. They do not get anything for selling a rate increase. They do get something if they sell a benefit increase. If somebody is at a $1,000 of monthly indemnity and they go to $1,200, the field will be compensated on the additional indemnity sold. But if we put in a rate increase, the field gets nothing for that.

Here's what I call overinsuring by underinsuring. There are several reasons why we've seen this come up. One is the not-subject-to-underwriting limit. There are many situations where the employee may not think they can make it through underwriting, and they would prefer not to take the chance, so they'll just go ahead and buy up to the not-subject-to-underwriting limit. The account reps in our company in some situations may encourage that, much as we don't like that to happen. They know what things are going to get knocked out, so they'll act as an intermediary and assist the educator in making that decision of whether or not to go to an indemnity level that is subject to underwriting.

The second issue, of course, is cost. There are many situations where the account rep will say, "You're eligible for $1,200 a month." And the person will say, "Well, I don't want to pay that." And we end up with situations where the individual may say, "I'll buy $1,000 a month." Now all of a sudden they're not buying full 60 percent of salary; they're buying something in the 40–50 percent range.

Of course, the other issue is that each of these plans is sold just once, and unless you go back and sell that benefit amount increase over the course of a couple of years, your income is going to go up while the benefit amount is not increasing.

So what does this do to us? Well, the main thing it does is reduce the benefit that we pay to a minimum benefit. The majority of our plans are $100 monthly minimum benefit plans. After the first year when all the offsets kick in—the teacher retirement, Social Security, etc.—these people may well be receiving a $100 monthly indemnity. From a premium perspective it doesn't matter to them whether they bought a $1,000 plan or a $1,200 plan, they're still getting $100. From our perspective we're compromised, because we're not getting the premium on the extra, say, $200 of monthly indemnity. And we did not price it that way, so we have a problem.

Then we also have an expense issue that goes along with it. We basically priced this product assuming people are going to be buying 60 percent. If they don't, the unit costs tend to be a higher percentage of premium, so we end up losing on the expense side as well.

I'll next talk about some of the solutions. Our official position is all new sales must be within $200 brackets of the maximum allowable. So if you're eligible for $1,200, you can buy $1,000, but you can't buy $900. We try to encourage the account reps to keep to this. It doesn't always happen. That's really an issue that we have to keep on top of to make sure that we're not slipping on it.

Once again, we have to make to sure that, if the teacher is eligible for the higher indemnity, they actually do purchase it. This requires annual reservicing and going out and talking to the people and telling them they're eligible for this additional benefit. We'd like them to purchase it. Every once in a while we'll do amnesties where we'll say, "We'll let you buy additional coverage not subject to insurability, although there will be pre-X associated with that." We try to do that to get the monthly indemnity amounts up. As you know, I haven't been with American Fidelity all that long, but if we try all these steps and we're just not succeeding, then the natural conclusion is we're going to have to begin to rate for it.

Another area is two-income families for overinsurance. Being in the education market, the majority of our clientele are females. And there's a greater likelihood they are two-income families, and in those situations when you begin to factor in childcare and a number of other things, it's possible that the reduced disability benefit will support a two-income family. When you take a second income, which is taxed at a fairly high rate, and remove that and replace it with a disability benefit, the taxability issue is even greater than with a single-income situation. Cost of living or quality of living-wise, you may not be that much worse off after disability.

As an anecdote, we had a situation in a company I was with a few years ago, a group of commodity traders. They were an interesting bunch. We made a lot of mistakes that, Howard, you'd probably appreciate in terms of not getting the correct tax information from them. Essentially it turned out to be a group of people who knew how to work the system. They would come up with tinnitus ear problems, and all of a sudden their spouses were trading for them. They would trade on the telephone. And, of course, the problem we ran into as well is that commodity traders are pretty high-energy, on-the-edge people, and they came to us as a group and said, "We have this contract. You're going to pay us, and just try to stop us." It was a very difficult thing.

We write a number of plans that provide no offset for the first 12 or up to 24 months of disability. That certainly is going to provide a situation for double-dipping. Sick leave is another one. If we're not rigorous in terms of determining how much sick leave these individuals have, we're likely to be overinsuring for a period of time. Our account reps are also very good about identifying potential maternity issues, basically suggesting that if an insured is going to have a child, they should purchase this plan, as it will pay when the insured is out on maternity leave.

In conclusion, overinsurance is a fact of life in the voluntary market. The best we're going to be able to do is manage it, not eliminate it. I think our situation is unique given the way that we market and our industry niche, but I think everyone has to look at his or her own experience and come up with conclusions on how to address it. I believe that active management is a must. You have to keep on top of overinsurance issues and make sure your premiums are appropriate for the situation.

MS. MITCHELL: Thank you all for your presentations. I'm going to open the floor up for any questions or comments. If you have a question please step up to the microphone and state your name.

MS. DEBRA SUE LIEBESKIND: I have a question regarding the education marketplace. What have you been seeing in terms of claim seasonality in the summer?

MR. SCHWISOW: You have to be actively at work in order to make a claim, so by definition we see a much lower incidence in the summer months. Incidence during the fall is not as high as in the spring. The first five months of the year tend to be the worst.

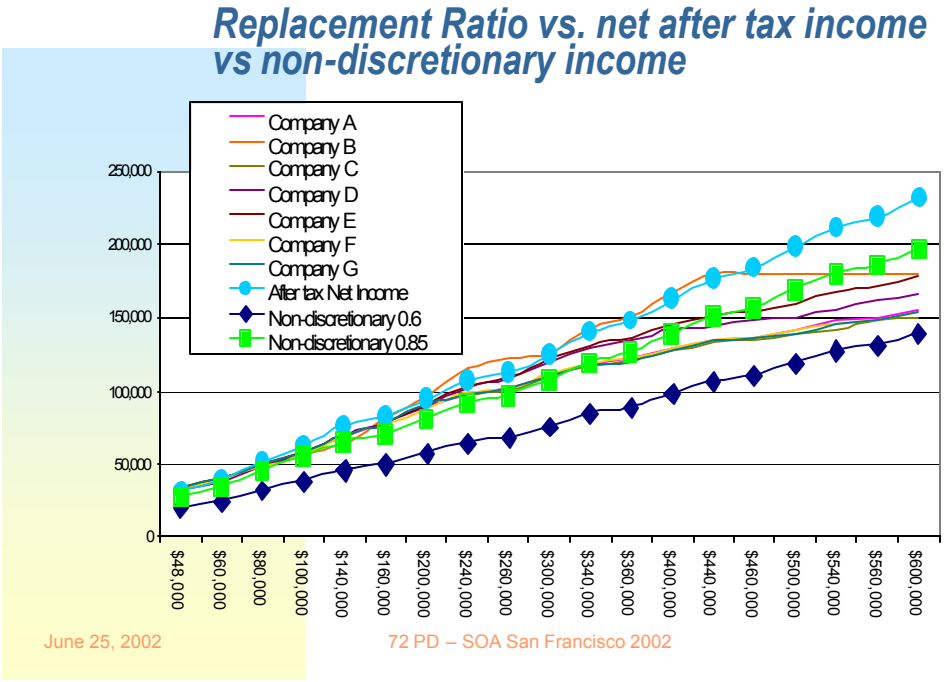
MS. LIEBESKIND: I have another question regarding the follow-up to getting benefit levels increased over time. Have you done that in any other fashion aside from face-to-face marketing?

MR. SCHWISOW: Our primary method is to sit people down in a one-on-one setting and talk through the product availability. This is much as the old individual life salesman would have done in the past. We're doing a little bit of Internet stuff, but we are more face-to-face.

MS. MITCHELL: I have one question for Howard. You briefly mentioned that you're careful about who you give the residual rider to. Can you elaborate a little bit as to why?

MR. ROSEN: There are some occupations where we are very careful, for example, real estate agents. Any time you have a situation where the insured can manipulate his or her income in a residual situation, the insured will do so. If you're on an other-than-salary basis, such as a commission basis, and you anticipate a claim occurring, you can push all of your income to just prior to what you will claim as the onset of disability, so that immediately after you have a huge loss of income. Therefore, the residual benefit will be greater. Now, this isn't something that happens with every insured who has the opportunity, but don't forget that it only takes a couple of extra claims to throw your DI line out of kilter. If you give someone the opportunity, or if you give your entire population the opportunity to select against you, some will.

Chart 1


Replacement Ratio vs. net after tax income vs non-discretionary income
Company A
Company B
Company C
Company D
Company E
Company F
Company G
After tax Net Income
Non-discretionary 0.6
Non-discretionary 0.85
250,000
200,000
150,000
100,000
50,000
0
$48,000
$60,000
$80,000
$100,000
$140,000
$160,000
$200,000
$240,000
$260,000
$300,000
$340,000
$360,000
$400,000
$440,000
$460,000
$500,000
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$560,000
$600,000
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