RECORD, Volume 29, No. 2*

Spring Meeting, Vancouver, B.C.
June 23–25, 2003

Session 85PD
New Opportunities in Individual Disability Insurance

Track: Health Disability Insurance

Moderator: DANIEL D. SKWIRE
Panelists: STEPHEN MILLER†
THOMAS K. PENN-DAVID‡
DANIEL D. SKWIRE

Summary: The individual disability business is alive and well. After many years of decline, the industry is now experiencing double-digit growth in sales and profits. The panelists in this session discuss the reasons they believe there is an optimistic outlook for the individual disability business, such as the growing need for individualized coverage, advances in risk management and the variety of possible product solutions. The panelists discuss why offering individual disability products makes sense for insurers who specialize in a variety of other product lines. This session provides quantitative and qualitative evidence of the opportunities that exist in the individual disability insurance market, along with specific discussions of different product approaches.

MR. DANIEL SKWIRE: Tom Penn-David is the second vice president and head of group operations at Munich American Reassurance Company. You might be asking what the head of group operations is doing on a session on individual disability insurance. Tom is a veteran of the individual disability insurance markets having served as a marketing representative for individual products at Munich for many years before his recent move over to group disability insurance.

There's already been some great discussion at this meeting about some of the trends and activities in the individual disability market from the report of the experience committee on to some of the financial experience over the past year. What we're going to do now is turn our eyes forward and think a little bit about the

†Mr. Miller, not a member of the sponsoring organizations, is vice president at Disability Management Services, Inc., headquartered in Springfield, Mass.

‡Mr. Penn-David, not a member of the sponsoring organizations, is second vice president at Munich American Reassurance Company in Atlanta, Ga.

future of the individual disability market.

Steve is going to begin our session with an overview of sales potential in this market and will talk about some of the future prospects for doing business in individual disability insurance. I'm going to talk about a few specific opportunities in the market, focusing on nontraditional approaches to individual disability insurance, and then Tom is going to talk about some of the risk management issues involved in the individual disability market.

MR. STEPHEN MILLER: The industry has worked hard to pull itself out of what was 13 hard years of losses and post six dramatic and consecutive years of fundamental improvement in economics. On top of that, there is some significant sales growth. A foundation has been laid for future profitability, some innovations and significant sales growth.

What I'm going to cover is my perspective of where the market is today, how you would characterize the disability insurance (DI) market, what the real sales potential is, and what the future prospects are. If I were a new carrier evaluating this business, what markets would I look at and what market attributes would I most value?

Most insurance companies today face the same issues. They face the need to grow their top and bottom lines. They need to diversify their distribution and revenue sources. They need to create a value-added proposition that doesn't squeeze their margins any more than they're already being squeezed, and they face the challenge of how to sell multiple products to the same customer effectively. DI may be the answer for some of your businesses as you put together your strategy to execute on those challenges.

To characterize where the market is today, you have to consider a little of the history. DI is a business that's characterized by a lot of rich history that has some valuable lessons that we need to remember and hold dear. It's an industry that is dependent on risk management discipline. When risk management discipline takes a back seat to marketing, when marketing drives the bus, and there's not a balanced decision-making process, losses tend to emerge, so that discipline is absolutely critical.

Everyone probably knows that from 1986 to 1998, the industry threw off negative profit margins. Those profit margins emerged through a failure or breakdown of risk management discipline and overconcentration in the medical profession with some significant socioeconomic shifts in motivation and earnings in that field. At least half of the companies that were in the business got out.

The companies that remained rolled up their sleeves and did nothing short of miraculous work to turn things around. They accomplished this not by doing any one thing or performing any magic, but by executing a lot of fundamental areas:

adjusting premiums, tightening underwriting, investing in more sophisticated and rigorous claims management, inventing new markets and getting a better spread of occupations through a multilife focus. Little by little, profits emerged, and the industry gained some momentum.

Today, individual disability insurance (IDI) is characterized by restored profit margins, and while we learned earlier at this meeting that the overall profit margins dipped a little in 2002, they still remain at historical high levels that haven't been seen since the early 1980s. Encouraging is a sign that active writers in the business saw continued profit margin improvement in 2002, which is significant. For the most part, the reserves have stabilized. We learned in Bob Beal's session that claim incidence appear to have improved. The settling out of the managed care crisis from the tightening of underwriting seems to have had an impact.

The year 2001 showed some nice double-digit sales growth, and 2002 looks like it's not quite double digits, but close to it with an eight percent growth in noncancellable sales. I would characterize the DI market today as one where the product is badly needed and not a lot of people have it. When I evaluate markets that I think carriers should get into, that's one of the first things I ask myself: Do people need this product, and do many people have it today?

Not a lot of people have disability protection. It's a glaring weakness in the financial plans that we put together. While the industry's done a great job of getting concentration in the medical profession, you can see that most other workers don't have IDI coverage. If you roll it all together, it's widely believed that about 2.5 percent of U.S. workers have individual disability protection, and about 30 percent of U.S. workers have group LTD protection. That leaves a huge block of people who are not protected against long-term disability .

As a matter of fact, the ACLI published a statistic that is compelling. It said that 82 percent of U.S. workers either did not have long-term disability protection or feel their coverage is inadequate. That means for producers who are selling financial planning, almost every customer they're talking to is a sales opportunity for DI.

One of the reasons so few people have it is because there are not a lot of carriers in the business. It's a concentrated business as a result of the fallout of the mid-1980s through mid-1990s. If you look at the top 10 carriers in the business, they represent 90 percent of new sales, which is double the concentration in the life insurance business, so there are not a lot of carriers in the business. There's not a lot of competition other than a few markets that I would characterize as highly competitive.

Most importantly, consumers are more vulnerable today to a loss of income than they've been in some time, and the reason they're more vulnerable is threefold. First of all, income is more volatile these days because it's tied more to backend bonuses and performance bonuses that aren't guaranteed, so income can bounce around year to year. If you're coming off of a couple down years of income, you may be vulnerable to disability and a loss of income.

As another point, group LTD typically doesn't cover those variable bonuses. You get a larger percent of income that is not protected. During a period of long-term disability, you're going to have to find some assets to liquidate to cover your expenses. The reality is household assets are tied up more in illiquid holdings and less in the liquid bank deposits that would be readily on hand to cover expenses. Bank deposits over the past 20 years have halved as a percent of household assets, while equities have increased by 50 percent. Finally, households have more debt today than they did 20 years ago, and as you look at the debt ratio to disposable income, it's risen from 12.5 percent to 14.3 percent in 2000.

There are a couple employment demographics that you should think about because they create greater need for disability insurance. The obvious one is we've got a workforce that's aging. The baby boomers are hitting 50. Currently, the workforce is represented about 30 percent by workers over age 50. Ten years from now, it's going to be about 40 percent, and this is a group of people who have found their assets and their savings significantly adjusted by the equities market over the past several years.

They don't trust Social Security and Medicare, and these people are in a position where they're going to have to work a little longer than they planned on working before they retire. These people are highly dependent on the ability to make an income over the next 10 or 15 years before they retire. They're also people who are at the highest risk of disability.

At the same time that you've got this massively increasingly older-aged group of workers, you've got younger workers coming on the scene who have increased mobility. With the increased mobility, they're going to demand more portability and customization of employee benefits. Today it's believed that the average American worker has 10 different jobs and three different careers. That's going to increase. Portability and customization of disability benefits will become more important.

The movement of employee benefits to voluntary basis is also a significant sales opportunity going forward. Everyone knows that health insurance premiums are going up. In 2002, they rose 15 percent. While employers have passed some of that cost down to employees, overall benefit costs have almost tripled over the past 30 years. As disability benefits become more voluntary and as employees have to pay for the coverage on their dime, they're going to be more selective on whether their coverage has portability, whether they can customize it to their needs and whether they have richness of coverage. I'm speaking from personal experience. A few years back when my employer dropped its group long term disability coverage and made me pay for it, I went out and bought an individual policy because once it was my dollar, I wanted the best coverage I could get. I do not think that's an isolated situation.

Hopefully I've convinced you that there are a number of demographic trends in our society that will create a greater need for DI. What are some of the characteristics of the best markets to enter if you're a carrier not in the business or if you're a carrier looking to expand operations? These are the characteristics I would look for.

I would look first for a market that gave me a good spread of occupations, It's infinitely easier to predict occurrence of accidents, heart attacks or cancer than it is to predict a work ethic in terms of work motivation or socioeconomic shifts by occupation. The best thing to do is get the best spread of different occupations in industries that you can. Because you're subject to minimum loss ratios, your management of expenses is critical to maximizing profit margins. I would look for markets that had low acquisition expenses, markets where you don't have to break the bank on compensation, markets with agent- and customer-friendly underwriting and markets where you've got reduced motivation for antiselection.

I love selling disability insurance as an ancillary benefit, as an add-on to sell something else, and the reason I think it's so effective is so many people don't have any disability protection that adding a little DI, whether it's wrapped around a retirement plan, a mortgage or a life insurance policy, is still a good thing in pushing DI out to the masses because the masses need affordable, simple solutions. I'd look for markets with limited competition and limited market penetration, and that's most of them right now.

One area to look at is the transactional markets. Banks grew their insurance premiums 42 percent in 2002. Banks are a viable and interesting distribution opportunity. If you're looking to expand your distribution, take a look at a mortgage DI product or attaching the DI rider to a life insurance contract. Bank representatives are looking to increase their revenue. There's not a lot of revenue in selling just that term insurance. If you can add on a disability benefit at the same time that you're underwriting the life, in one transaction you can double the revenue to the branch representative. They love that kind of stuff, and obviously the banks love it.

If you're selling retirement plans, the biggest risks to that retirement plan being completed is clearly a long-term disability. It makes all the sense in the world why you're selling a retirement plan to at least consider wrapping it in disability protection. I should have mentioned that I believe that 49 percent of mortgage foreclosures are caused by disabilities, so that's another reason why banks like to sell it. They want to improve the persistency of the underlying mortgage products.

In the middle-income market, it's such an underserved and underpenetrated market with so few carriers effectively serving it that I think it's a great market to consider. You can go in with a simple nobells or whistles type of product design. Affordability is key. The reality is there are a number of companies selling financial planning to middle-income families that don't have DI in their financial needs analysis. That's a huge hole. How do you not consider a long-term disability risk in putting together a financial needs analysis for a family?

Finally, look at the voluntary benefits market. I think LIMRA reported that over the past five years, the number of employers offering 100 percent employee- paid products has doubled. The voluntary benefits market is a hot market. Any company with a large group LTD block is sitting on an excellent opportunity to cross-sell IDI to executive populations. The group carriers have the ability to go in and slice and dice and identify their most profitable blocks of business and target them for effective cross-sells. I think that's an interesting market, Obviously the worksite marketing, both employer-paid and voluntary, is attractive these days.

What are the benefits to a new entrant? They are diversification of revenue, diversification of profit source, being able to go out and get new distribution and being able to get a deeper cut of your existing distribution. The large producer groups are hungry for disability solutions. Banks are hungry for disability solutions. I think a number of producers that left the disability market would embrace a new platform that was more agent-friendly and met more basic catastrophic needs with more affordable, simple solutions. Financial planners are looking for disability solutions. I saw a survey that Hyatt put together that said more than 80 percent of financial planners want a simpler, easier-to-understand disability product to sell.

DI facilitates effective cross-selling because you're going in, looking at customers' income and looking at their cash flows, and it lends itself nicely to a life insurance sale or to a retirement product sale. The economics are good today, but obviously DI is a cyclical business that's got some inherent short-term volatility and risk that need to be considered.

Among the challenges for new entrants into the business is setting up your risk management infrastructure. It's a business that absolutely demands it. It's a business that pays big dividends if you execute well, but getting experienced claims underwriting and actuarial resources are challenging because not a lot of experienced people specialize in this business. If you can't get the right people in-house, looking to outsource a partner may make sense.

You've got some systems requirements. You obviously need an integrated administrative and claims system. I know a number of carriers are strapped with old legacy systems that may not have the flexibility to analyze emerging trends in your business. It's important to proactively monitor experience and look for trends and proactively take actions to correct the problem before it overwhelms you, and obviously with a big investment up front in infrastructure, you've got a scale issue that you need to worry about.

Regarding overall challenges for the IDI industry, perhaps the biggest one is while there's a great need for the product, there's not a great demand, and that's because there's not enough education and promotion in marketing other than need.

ACLI surveyed some small employers as to their attitudes and perceptions of disability and asked them what they thought the likelihood of an LTD occurring some time during their working years was.

Half the employers thought it was one in 50. I'm sure you know that closer to one in three workers would be disabled for 90 days or longer during their working years. The number is one in three, where there's a perception it's one in 50. Clearly we need to get closer to need equaling demand. We need to create more affordable product solutions. We need to get some of the producers that ran away from the business back in the fold. We need to get some of the new producers that have entered into the business to embrace DI. We need to look for new distribution sources.

DI sales will be a function of how effectively we grow our distribution channels. DI is about a $400 million-a-year new-premium market. That's nothing. That's less than one-tenth what the life insurance new sales are, and DI new sales should not be one-tenth of what the life insurance sales are. That to me speaks volumes to the future sales potential in this industry as we do a better job of marketing its importance and as we do a better job of expanding our distribution capabilities.

The only way to truly raise the bar on innovation and service is to get more carriers interested and active in this business. We need to create new markets, and most importantly, we need to hang on to the lessons that the industry has taught us over the past 20 years, especially as we've dug ourselves out of the mid-1980s and need to maintain profitability.

MR. SKWIRE: There's a famous opening sentence to the book "Anna Karenina" that reads: "All happy families are alike, but every unhappy family is unhappy in its own way."

This might be true of Russian peasants in the 19th century, but with respect to Tolstoy, I think the opposite is true in the DI market. I think that the companies who have struggled and ultimately some of the companies who have failed in the individual disability market have had a tendency to repeat some of the mistakes that have been made by other organizations. It's the same story over and over again.

On the other hand, I think the companies who have succeeded in this business and who have developed profitable blocks of individual disability business have been those that have developed customized solutions, that capitalized on the strengths of their own organizations and that are targeted for the specific markets where they have the most knowledge and experience.

The individual disability income market is not a one size fits all proposition. It's one where a customized solution will prove to be the best approach. We're going to talk about some nontraditional approaches to the market that may work for organizations with different types of strengths and weaknesses. I'll mention briefly, and this is a topic that Steve touched on: what are some of the reasons that organizations might want to consider nontraditional product offerings in this market?

First, it's a good growth and profit opportunity. Many of the offerings that we'll talk about are specifically targeted toward some of the under-penetrated market segments that Steve mentioned in his presentation. Second, it's an opportunity to leverage your existing distribution channel, an organization in which you will have invested significant time, money and training, and why not provide them with as many products as possible to sell? Finally, it's a means of broadening the offerings that you have for your current customer base. If you're already talking to people in a certain market about life insurance and long-term care and group disability, why not develop a package of individualized offerings that would also be of interest to them?

I do want to say up front there are some common pitfalls to doing business in the individual disability market, and these are some of the mistakes that we have seen organizations make in the past. One is it's easy to be seduced by the top line in this business. There are many things you can do to put a lot of individual disability premium on the books in the short term, and they aren't all kinds of things that you want to do to have a profitable block in the long term.

It's easy to take shortcuts in underwriting either on the medical side or on the financial side by not getting appropriate information about earnings and income replacement. It's easy to underestimate the importance of claim management and to view it as a customer service function rather than a risk management function, but that's a critical mistake in this business. Finally, it's hard to overemphasize the importance of having good experience data and good experience studies to interpret that data as you manage this business.

Individual disability is a long-tailed business, which means that the financial results are heavily dependent on the reserves that you set up for the business, which are heavily dependent on all the assumptions that you have to make to put into those reserves. It is possible, depending on the assumptions that go in there, to have emerging experience patterns be disguised for a long time, and it's important to do that kind of analysis properly to get early notice on the trends. This is something that Luce Giroux talked about in an earlier session as far as managing runoffs on claims and getting the early notice of the trends.

As we talk about some of the specific opportunities for nontraditional disability offerings, I'll give you a quick definition of what we're talking about. I'll discuss some of the keys to succeeding in that particular product offering, identify some of the common pitfalls specific to that offering and mention the profile of what a successful entrant would look like.

Before we go nontraditional, let's spend a minute on the traditional offering, What I'm talking about is an income protection product sold one life at a time, when the benefit is a specified monthly indemnity as opposed to the group model of a percentage of income replacement.

The key things to think about in this market are first that the underwriting and the claims functions are more difficult than they are for life insurance if that's where your background is. There are many specific medical conditions, such as sore backs, muscle problems or chronic pain problems that could have a significant impact on disability experience that are almost irrelevant for the purpose of assessing mortality risk. Likewise, the claims function is more complicated. There's not much need for rehabilitation programs on life claims, but it's important to have all the medical research, all the financial support and all the occupational rehabilitation in place for disability claims.

I mentioned before the long-tailed nature of the business; it is important to be on top of experience trends. It's a good idea in many situations to start out slowly if you're jumping into this market. It is a complicated business, and sometimes it takes a while to hit your stride and to understand what some of the offerings are. You need to assess why companies are doing what they're doing. Those are a few things to keep in mind here. The kind of organization that tends to succeed as a new entrant in the traditional DI market is a company that's comfortable with risk management. Any organization that has a serious medical underwriting function as part of its existing business is probably well-set up to enter this particular business line.

The next offering we'll talk about is multilife individual disability, and someone told me once that it sounded a little bit like an oxymoron, so let me describe exactly what I mean. I'm talking about the individual policies. These are still individual disability insurance policies, but they're sold in employer-sponsored settings. You might be selling anywhere from three or five up to hundreds of these policies at one time to people who work for a single employer.

Many times these plans are packaged with group insurance, with perhaps an extra layer of coverage on top or a different form of coverage for a segment of the population that's carved out as a special class. Many times these plans can be offered with some form of simplified underwriting. The thing to keep in mind is that it's important to have a good knowledge of the group disability business if you're going to roll out a multilife offering. That's important because the plan design for a multilife offering needs to match up well with the underlying group coverage.

There are a lot of different creative ways to package together the multilife offering with a group offering. I've seen these with a layer of group coverage below and some individual coverage written on top of that as a buy-up. It's called a combo plan. I've seen reverse combo plans where you have a layer of individual on the bottom with a group coverage on top and any other form you can imagine such as side-by-side offerings, different elimination periods and benefit periods that fit together. There are pros and cons and good reasons for all those different designs, but to be successful in this market, you need to understand the interactions between the individual and the group and what makes those attractive purchases for the customers.

Another important point is to have a reasonable and realistic view of the underwriting process. I mentioned before that one of the advantages is you can often use simplified underwriting, something like a guaranteed issue program, for example, but if you are going to have an offering that uses group underwriting techniques—a guaranteed standard issue offering—you want to be sure that the risk you're assuming is analogous to a group risk. You want to have a high participation rate, for example. You want to take advantage of plan provisions, such as a pre-existing condition exclusion, or underwriting guidelines, such as actively-at-work requirements, to make sure that the risks you're getting in the door using that group underwriting technique are similar to something that a group organization would be taking in.

Finally, because this is a segment of the individual disability market, it's gotten a lot of attention recently. As you may have seen in the experience committee report, it's one that's been generally more profitable than the traditional DI segments. It's become a competitive one recently, and that's something you should go into with your eyes open. If you're going to participate in this segment, there will be a lot of competition, the same as we often see in the group market. It's something that you should plan for and design new products around and watch your underwriting approaches so that you're competing in a prudent fashion.

Another means of offering individual disability insurance is to do it as an adjunct to a life insurance policy, and probably the most common approach is to offer the disability in the form of a rider on an individual life policy. In some cases, companies will even have connections between the disability rider and the life policy by making links, for example, between the benefit amount of the disability and the face amount of the life insurance or other types of provisions.

Some of the keys are to remember that the design of the disability income should be simple. Usually the reason for doing this is to take advantage of a life agency force and have this be an "Oh, by the way" kind of sale, as in "While we're talking to you about life insurance, maybe you should be thinking about income protection, as well." To take advantage of that, you don't want the explanation of that coverage to be too complicated. A simple product design proves to be most effective for these offerings. You do have to keep in mind, however, that it's still a real disability offering. For that reason, it's important to remember that the underwriting and the claims functions that we talked about before still apply to the disability income rider.

For example, a typical life insurance application is not going to have all the medical questions you need to underwrite a disability risk, and I often see these types of plans set up using a life application but then with a supplemental DI questionnaire that has a half dozen or so questions that gets used. That's the sort of risk technique that needs to be considered when you're working with DI riders. I think life companies with an agency distribution are natural candidates for this kind of offering because it fits well with their current business.

Steve briefly mentioned mortgage disability as an opportunity for selling individual policies. Let me clarify what we mean when we say that. We're not talking about true credit disability, which is a specialized product usually sold as a single premium as part of the process of taking out a loan. This is a different way of positioning a simplified individual disability policy, with the idea that the benefit is specifically designed to cover your mortgage payment in the event of disability.

There are some things to consider. First, overinsurance can be a risk on this type of offering. Remember that most people make their mortgage payments out of their income, and if their income is fully protected by group coverages and individual coverages, they probably don't need this type of offering on top of that. This is designed for folks who don't have as much income protection as they need, but by talking to them about a specific need, such as to cover a mortgage payment, it's a good idea to help them build awareness for the need for income protection. Make sure you're capturing information about the other types of disability coverage they may have so that you're not entering a problem with overinsurance.

This is also a product where agent training is important. You need to make sure the agent is explaining the risk and how it fits in with the product they have to the extent that the product is not a perfect fit with the mortgage. For example, if you're selling a five-year benefit period on the disability product for the mortgage to go on longer than that, you need to make sure the agent is able to explain some of these issues and to communicate the need so that the buyer understands the advantages of the product. Once again, the profile of a successful company would be a life or disability organization that's comfortable both with the risk management side and with talking to its clients about financial planning. This is certainly part of that package.

Retirement savings disability products are probably the most complex of the benefits that we'll talk about. These benefits are designed to replace both employee and employer contributions to a defined contribution retirement plan in the event of disability. The premise of these products is that the disability benefit is not paid immediately to the claimant in the form of a cash benefit as most other disability benefits are. Instead, it's deferred in some fashion so it will be received in cash by the claimant after that person is retired.

There are a lot of ways to do that. The benefit itself can literally be deferred, or it can be paid into some form of trust to the benefit of the claimant. It can be done into a deferred annuity and in some cases into a qualified pension plan. There are group disability product designs that now can get folded into a 401(k) program. That last one's a little beyond the scope of what we're talking about here, but it's much insuring the same type of risk and need.

The advantages are clear. This is a great financial planning tool for organizations that are comfortable talking about some of these issues with their customers. This type of benefit structure is a significant improvement on the lifetime benefit periods that caused so many problems for individual disability insurers in recent years. The premise of a lifetime benefit period was to provide retirement income, but it was so difficult because it continued to assess the claimants' work ability after their retirement age.

It's a difficult concept. It's hard to manage, and you're not going to have much success getting people to return to work when they're in their 70s and 80s. This type of benefit still provides retirement income, but all of the disability determination is made during the working years, and that money is set aside to be paid later, so it's much better designed from a risk prospective.

There are some challenges here. These are complicated benefits. There are tax issues that have to be thought through carefully according to the specific product design that you're using, and there are legal and other issues that go along with some of these. I think that any organization that is comfortable with asset management, annuity businesses, employee benefits, etc., and has some knowledge of the life and disability market is a great candidate for offering this type of product.

I will switch gears a little bit now and talk about some simpler types of disability offerings. Worksite disability, sometimes also called payroll deduction, consists of a simple short-term disability product. By short term, I mean anywhere from about six months to one or two years' worth of benefits. I don't usually see these much above two or three years' worth. The products are sold through payroll deduction, and they are generally medically underwritten but in some kind of simplified fashion.

The thing to remember is that successful worksite offerings are simple in nature. They're sold through perhaps employee meetings or a face-to-face enrollment process, so you need a design that can be explained quickly and easily to a large group of people. The product is also a little different in terms of the way it competes with other companies. Individual disability offerings are often thought of as being spreadsheeted, where you have agents and brokers comparing you with other organizations and going provision by provision and rate by rate.

This product doesn't get sold that way. There is a sale that happens at the employer level, but when you get down to the point of persuading individual employees to purchase the coverage, the product's already been endorsed by the employer, so it's a buy or no-buy decision based on how much they like what they're seeing. That means that the price point is important and that the cost needs to be affordable relative to the person's income, paycheck and expenses, but the price competition from company to company is probably less important on this product than it is on other types of individual offerings.

The key to success is a successful enrollment process. It's getting as many people as possible to sign up for the business, which helps not only your growth, but more importantly your risk management. All this discussion about simplified offerings and price point is designed to build up that enrollment offering, and that's why the successful companies are the marketing organizations. They have a broad portfolio of payroll deduction, worksite products and a well-designed technical platform to help them manage the enrollment process.

Association and affinity markets have also been an interesting channel for disability insurance. To distinguish between those two briefly, the term association markets refers to professional associations. It's a group of people all of the same occupation—SOA is an example. In fact, I think SOA just rolled out an association program.

Affinity groups are organizations that are connected by anything other than the job essentially, so they could be an alumni association, customers of a financial institution, readers of Tolstoy novels or any other example you can think of. In the past, the association and affinity markets have been heavily weighted toward professional associations. Those products have usually tended to evolve to look more like individual disability offerings with fairly generous benefits. I suspect that the future growth potential in this market might lie more on the affinity side, with offerings that are a little simpler and that look a little more like the worksite offerings that we just discussed.

This market is almost a perfect combination between the individual and the group businesses. Participation rates are low, so you're talking about individual risks that need to be individually underwritten, but at the same time the associations and the affinity groups have a strong connection, and the cases are managed like a group risk. They can come and go all at once, they send out requests for proposals (RFPs), they move from carrier to carrier, and you have to talk about renewal ratings. A lot of group dynamics go on, and a company that's going to be successful has experience in managing both the individual risk and the dynamics of a group case.

Direct marketing products do exist in the DI world. They are not a large offering right now, but a year or two ago you started to hear people talking a lot about Internet products for DI. It was always presented as a hot new topic, but it's just a way of revisiting direct marketing. Direct marketing products, to be successful, have to have the simplest of all plan designs. They're sold via mail, the telephone and the Internet. It's not even the communicated in the form of a quick glossy brochure that shows up in someone's credit card bill one day. For that reason this is largely a marketing game. You have to be a good marketing organization or have a partnership with a good marketing organization to succeed in this kind of market. At the same time, you have to think about the overall financial picture of these products. The expense structure of a direct marketing product is probably more important than it is for other types of DI. Things like response rates and the cost of the mailing can overwhelm the risks that you're taking on the morbidity side from these products if you have a well-designed risk. It's important to keep an eye on the expenses as you're doing your management.

Finally, given the nature of the way you're selling the business, the product needs to be designed to support a minimal level of underwriting, so you're not going to be able to sell the same kind of traditional DI product that you do. You need to design something specifically for this channel.

The last type of product I'll mention is almost an offshoot of a direct marketing one. It's closely connected to that, and that is accident-only DI. I'm talking again about a short- to medium-term product that pays monthly benefits for accident disabilities. This isn't a lump-sum personal accident product. This is an accident disability product.

There are different uses for this product, which is one of the things that makes it interesting. It can be used as a form of a direct marketing product. It can be used in any situation where you need a simple design to get it explained quickly. It can be sold as an add-on to other types of coverages, and I've seen it used also as a substandard disability offering. In a case perhaps when someone's been declined for a traditional disability product, an accident-only product might enable you to offer some level of coverage to that person.

One of the big advantages is typically these products do not require medical underwriting because you're insuring only future accidents that happen after the policy's issued, but it is important to remember despite the easier underwriting and despite the simpler product design that the claim management function is still important. Rehabilitation is still a big concern, as are medical management and even financial management, depending on the situation of the specific claimant.

The organizations that we see succeeding in this type of product would be a good marketing organization. It's a great fit for an organization that does not have tolerance for underwriting. An organization that perhaps hasn't had any experience in the disability market before and doesn't want to deal with some of the messy underwriting might want to consider starting out with an accident product.

That concludes our whirlwind tour through nontraditional individual disability products. As Steve said, this is a great time to be considering new opportunities in the individual disability market. The need is rising, and some of the results that we've seen have been favorable. We've seen some good signs, and no matter what the strengths of your organization and no matter what the markets are in which you currently do business, there's some type of approach to the individual disability market that will be a good fit for your organization.

MR. THOMAS PENN-DAVID: . Steve and Dan have told you about these opportunities. They said to go for it, to do this and find this product. I'm here to say, "Let's be slow." Recapping what Steve and Dan have said, disability is a promising market opportunity. However, we also note that lots of carriers have lost money and have left the market. Therefore, our conclusions are either don't get in at all or else do it right.

Doing it right has two components. One is you have to sell enough to make it worth your while. If you never sell enough to cover your costs, you've wasted your time, and we can certainly name companies for whom that's the case. The second part of doing it right is making sure you use sound risk management, and that's what my focus will be.

We all get paid here to accept risk. That's what we do as insurers, but we also have to manage it, or we won't be around for long. The basics of risk management are straightforward: Identify your risks, quantify them and then figure out how you can accept them or else ameliorate them. Risk management tools for DI can include your marketing mix and how you work with your field force and control it. They include your product, contract and pricing design. They include both individual and multilife type underwriting. They include how your claims management is done. For the rest of my presentation, I'll be talking about specific elements of risk.

Incidence risk is the most obvious risk in a disability product. If more people are disabled than you expected, you will probably lose money. Throughout the following discussion, I considered a series of little charts given to me by an actuary. The basic model is targeted around a standardized internal rate of return (IRR). It's a simplified set of assumptions for morbidity, expense and interest. We wanted, in each case, to look at how a given component of risk affects what you would need to do to premium if you had a change in that component of risk.

For instance, we said that if you have a 10 percent increase in your incidence rates, meaning a 10 percent increase in your claim costs, you would need at different ages various increases in your premium to cover that increase. The dynamics can be fun for an actuary to discuss. The question is what do you do about it? Consider the various alternatives to manage incidence risk, to try and contain the rate at which people are disabled, start with your medical underwriting.

Responses include reasonable replacement ratios, which are something that we're fond of talking about until we're blue in the face. We can have longer elimination periods. The industry discovered throughout the late 1980s and early 1990s the difference between 30-day and 90-day elimination periods and how seriously that can affect incidence. We can go to more conservative benefit triggers. The endless debates that we've all had about pure own occupation, own occupation and not working, any occupation, and going into even more conservative loss of earnings contracts. Finally, we need proper claims handling, particularly with the traditional product. As Dan has said, you don't go into this unless you have some good source of claims expertise.

Continuance risk is the other half of the Janus twin of morbidity. What happens if people don't come off claim fast enough? It's not as dramatic, at least we were modeling it. Again, the point is that different products, different designs and different ways of allocating will come up with different results, but they will all be significant. This can have a major impact on your profitability. What can you do about it? Limit benefit periods. Lifetime benefit periods are rare in the market now, and where there is a need, the agent says we've got to protect that postretirement income. That's where you start talking about the products that do the annuity type or pension completion benefits.

Use reasonable replacement ratios. If somebody is comfortable on claim, you can expect him to continue doing it. The industry has gone to exclusions or limitations for claims relating to mental/nervous and drug/alcohol causes, but rarely does it use the limitation/exclusion on self-reported symptoms. I'll admit that I see more of that on the group side than I see on the individual side. I don't know if that will change, but that certainly addresses that cluster of environmental illnesses, carpal tunnel, fibromyalgia and other nondiagnosable claims. Again, focus on proper claims handling.

Payment risk is the risk that average payments are higher than expected. I occasionally see a company that has that as an explicit factor in their pricing model or their valuation model, but it's unusual. It can have a significant impact, though, if you expected to be paying out, for example, residual benefits at 50 percent and find you're paying a lot more complete benefits. To make sure that you understand and manage your payment risk, once again let me get benefit amounts. My theory there is that if you don't offer too high a payment of benefit, you won't be eating too many high payments.

Design carefully how your residual and partial integrate in your contract. We've seen some that make perfect sense, and we've seen some that don't. There was a letter by Art Friez at the end of last year that was delightful. He was praising an old contract that if you had any sort of residual would add it on to whatever income you have so that you would have more income after disability than before disability. As far as Art Friez was concerned, this was the best thing since sliced bread. Art Friez used to be a disability agent. He's now involved in other activities.

Finally, limiting your cost-of-living adjustment (COLA) benefits hasn't been relevant in the past four or five years. When we started actively writing disability at Munich, I saw a lot of benefits that were in the seven percent compound range with no caps on them. At the time, those looked like fairly scary things in terms of what type of payments could mount up over time.

Persistency risk flips both ways. At the front end, you've got a lot of expenses to cover. At the back end, you've got a sharply increasing morbidity curve. You can get whacked either way, so it's not simply that more persistency is better. My friend the actuary modeled both the impact of a 50 percent increase in the early lapse rates and alternatively what happens if you have few—perhaps five percent or two percent—or almost no ultimate lapses. Either case can be bad news, though the low-lapse scenario isn't quite as bad as I might have thought.

There aren't too many responses to that one. You can have conservative lapse assumptions. My theory on the relationship of benefits to premium is you're going to get lower ultimate persistency if your benefits are not too high relative to income. That's the relative richness of benefits. My theory on the benefits to premium is that if it's not a good value proposition, you're going to lose customers faster. These are theories, by the way, and I would like to find an actuary to quantify them for me and tell me what the right number is as far as the relationship of benefits to premium.

Investment risk has been near and dear to all of us over the past six months. One question I had when I was kicking this around with my actuaries is whether this one is an unambiguous situation. I'll leave that as a question mark. Is it true in every single case that a sharp drop in investment return is bad for a disability product's profitability? The only out, I would imagine, depends on how you measure your metrics, but it also depends on whether your underwriting result is positive or negative and whether you were counting on an investment subsidy or not.

At any rate, my actuaries looking at it conventionally took a look at what you would need to do to cover a 50-basis-point drop in investment earnings. It varies by age, as you would expect, but again it's fairly significant, roughly four times the drop in earnings rates, or two percent to cover a 50-basis-point drop.

Here are some responses. There are theoretically some hedging strategies. I don't know that any of us has a portfolio large enough that hedging of investment risk on individual disability is a realistic alternative. That one's a hypothetical.

The second is a conservative assumption given that once you put this on the books, it will be there for the next 20 or 30 years. It would seem conservative, but over the past four or five years, I doubt we've seen an actuarial memorandum with an assumption below 5.5 percent. I think most of the products on the street right now are still at 6 or 6.5 percent, which looked conservative in the early to mid-1990s, but doesn't seem so right now.

The third response and way to manage investment risk—again it's a noncancellable product, which is not necessarily helpful—is to reprice periodically. As a parenthetical comment, and this may go to Mark's survey showing that we're all making too much money, I've been shocked that we haven't seen more repricing.

Almost every product that we're reinsuring right now was last priced in the mid-'1990s, in 1998 or 1999 at the latest, so I'm waiting to see a wave of new repricing coming in because we're not earning 6 to 6.5 percent right now on the new money.

Expense risk is the risk that actual expenses are higher than expected. This should be one of the more manageable risks that we've got built into the product. Responses include managing expenses. You've got expenses—off with their heads, every third person, or something like that. Another alternative to managing your expenses is to go to somebody like Steve, who is superefficient, has a massive claims shop that can churn them out like nobody's business and has a supermodern administrative system. Therefore you outsource some of your administrative expenses or develop stronger distribution channels so you can grow your business to match your expenses. I'll admit that's somewhat how I look at our reinsurance business because we're largely a fixed business, but I'm not sure that works for direct writers as a general rule.

Regarding combination risk, after we listed all the other obvious risks for the product (I haven't gotten into operational risk, moral risk and other risks we could assess), there are covariant events that could occur. When I think about that as a risk manager or an employee of a company that looks at risk management day in and day out, these are some of the toughest ones.

We're obviously seeing one right now in the economic downturn. Over the past day, I've seen not only the demonstration of what's happening to investment returns, but before that, in the valuation session on disability, there were Social Security claim rates for the past three or four years, and those are showing some nice rising patterns, both of them dramatically demonstrating what happens in economic downturn.

Another problem that we haven't seen but that those of us with gray hair can certainly remember are periods of awful inflation, where the absolute value of the payments you expected to pay were going up through the roof. Management of those things honestly stumped me when I started trying to think about what you do about it. A nonguaranteed rate sounds fine, but since the last time Dan was here when he was presenting a guaranteed renewable product, that solution doesn't seem to have worked out. We try to encourage clients to avoid certain combinations that look inherently risky, but overall that is a risk within an individual disability that I don't see how to manage other than by reinsuring it all to your reinsurer, and then letting it soak it up.

My overall conclusion is that risk is a big part of the product. Part of our overall mention when we talk about opportunities is that we see opportunities in disability, but we also see risk. We don't want people who are looking to expand their portfolio of products, to build new products or to add on disability products to skip or to ignore those characteristics. Those characteristics can be mitigated, but it takes some thought and some effort.

FROM THE FLOOR: My firm's been somewhat successful in matchmaking, which is another alternative instead of producing your own product or if you can hook up with another company and sell its product or in turn hook up with another company for it to sell your product. That's another alternative to investing the large amount of money it takes to develop this. That's true with any product. It certainly is true with this one.

MR. SKWIRE: Yes, that's a good point. There are a variety of joint venture relationships that can be put into place to help you offer products or find products for your distribution force. It can be anything from a simple marketing agreement, where your agents essentially act as brokers for another company's products, to something like a private labeling arrangement, where a product is getting filed with your company name on the paper. Maybe you take a little slice of the risk, but most of the work, such as the product design, and a lot of the risk, is essentially outsourced to another organization. Steve, I know that's an area where your organization does some work.

MR. MILLER: Yes. I think if you view manufacturing the product as a profitable investment, think that you can make money on it and want to enjoy that manufacturing profit, it makes sense to find a way to build it yourself. If you view yourself as a distribution company or you view the add-on product as leverage to your core business, it may make sense to import someone else's product, but it's the manufacturing profits that I find attractive.

FROM THE FLOOR: Dan, you mentioned on the worksite marketing end of it that the common product is the product design was a one to two year limited benefit period. Do you think there's a market for the longer benefit periods of, for example, five years or maybe to age 65, in the worksite marketing area, and why or why not?

MR. SKWIRE: That's a great question, and it touches on a larger question, which is where worksite products fit into the overall spectrum of disability products that are out there. There's a lot of discussion in the group market about voluntary disability products, and the word voluntary tends to encompass anything ranging from the worksite product I described, which is a short-term, simple design, to essentially a traditional LTD product sold to an employer, but with a lower participation rate. That kind of product is getting sold with longer benefit periods. I think there is some room for longer benefit periods in the worksite market. There are a couple of challenges, though.

The first one is being able to hit that pricing point and still provide a meaningful monthly indemnity to the purchasers because these products are most popular in lower- and middle-income markets, and people may not have a lot of money each month to spend. Once you kick that benefit period up to age 65, they may not be able to afford as high a dollar level of coverage, so that can be one drawback.

The second one is that you are dealing with participation rates that can be low. These are often less than 25 percent that you'd see on a group voluntary product and sometimes 10 percent, five percent and downward. The longer you go in the benefit period, the more underwriting you need to think about doing, and that complicates the process a little bit. I answered that two different ways. I think there is some demand for longer benefit periods, but I think it poses some challenges.

FROM THE FLOOR: You had mentioned that you've seen some carriers that pay disability income directly into a 401(k). Where can you get the tax advice to do that? Don't 401(k) contributions have to be earned income? How does that work?

MR. SKWIRE: I'm going to struggle a little bit on this one. There have been a couple articles in the "National Underwriter" recently that describe this in a little bit of detail. One came out in the first two weeks of May. There has been a private letter ruling recently from the IRS in regard to one company's specific design where essentially it was embedding an LTD plan within the 401(k) structure. It was all going to be completely tax-qualified. That was essentially the opinion that was sought in the private letter ruling, so it's all within the 401(k) plan.

FROM THE FLOOR: Tom, if I understood correctly, you said that a lot of your clients haven't repriced since the late 1990s?

MR. PENN-DAVID: Yes, that's correct.

FROM THE FLOOR: Have reinsurance terms unlocked fear in the last little while because of it?

MR. PENN-DAVID: No. Most of those terms have been last renegotiated back then. I raised the question about whether the low investment environment necessarily is a negative. If it lowers your target hurdle rate, and you're making an underwriting profit, you might be in a situation where your product looks as good now relative to your objectives as it did when you priced it originally, conceivably. I don't know of many companies that have explicitly lowered their hurdle rates in response to a lower risk-free, interest environment, but there has been a general underwriting improvement that I think has masked a lot of the disimprovement that's coming through interest rates.

FROM THE FLOOR: There are a lot of interesting ideas, a lot of optimism and a lot of different opportunities to be made here. We've got a couple of experiences at Standard that make me wonder about the potential success rate of some of the new ideas. One of the ideas was mentioned by the gentleman who talked about pairing up with another carrier or something for distribution. We had a fairly successful experience when we bought a block of business. We also hooked up with its distribution system and had pretty good sales. The underwriting result seems to be okay, but it's still early. It seems to be working, even though there are a lot of reasons those sorts of things can go wrong. You've got two different companies and two different cultures, so who knows why it works.

We've had another experience right within our own organization where our group insurance division is trying to sell group combo. It's put a lot of effort into that, and sales were not going well, although there are signs that they are picking up. You would think that you have a little more control in the second situation, that you'd be able to fire that one off and get some good results, and that you wouldn't have such good luck in the first situation that I described.

Among all these risks and success factors you described, maybe there's something fundamentally wrong with one or the other of these, or maybe there's some execution performance that's working one place and not the other. Are there success stories and failures that you can talk about?

MR. SKWIRE: I think there are successes and failures on these different opportunities. We did intentionally take an optimistic outlook. I wouldn't tell you that every person who has ever attempted to do one of these designs has been successful. I think companies do best when they begin with the premise that they will work from the things that they know.

I've seen a number of companies that have attempted, for example, to roll out worksite disability products. In some cases, those have been organizations that do a lot of other worksite products already. They sell life insurance products that way, they sell cancer or critical illness that way and they sell something else that way, and when they roll out a disability product, they figure out what works right with what they're already selling: That it's simple or that the system is this way.

They say, "We're going to do the product design so that it fits in the same system, even if that means we can't match everyone else's benefit," for example, and those tend to be successful offerings.

I've seen other organizations that might start from the premise that they sell a lot of disability insurance currently, they're in the group market or the high-end individual market and now they're going to do a worksite product to compete with some of these other organizations, but they may not have the system's infrastructure or the enrollment expertise to support that. In that case, they may find that to prove a difficult sell. That's one market where we've seen both successes and failures. I think for all these, you need a well-planned approach. It wasn't our intention to make it sound more simple than it is.

MR. MILLER: I would add that from my experience, the most successful launches are those that engage distribution early on and customize whatever is built around the unique needs of the distribution. I don't believe in the field-of-dreams approach where you build it, and they'll come. As an example, group benefits specialists may have certain ideas, preferences and preconceived notions relative to how the individual should be packaged with the group, how it should be sold and how it should be underwritten. If you engage them early and get buy-in, you get a commitment to sell it. Never put a product out there and hope distribution will take to it. The psychology never works.

MR. PENN-DAVID: I will throw in one other comment that's just an observation as a reinsurer. It's often a lot easier to get the people outside of your company to cooperate with you than it is to get the people across the aisle, and I've observed that phenomenon in more companies than I can think of at this point.

MR. SKWIRE: I want to take a Mulligan on the 401(k) question and take another shot at answering that because as we're sitting here talking, I'm remembering some more details about that. I mentioned that on that kind of product design, the group disability plan is embedded within the 401(k). Let me give you my best understanding of how that works.

I think essentially that a group disability program is put into place, and from the prospective of the participants in the 401(k), the group disability plan looks almost like another investment option. They select to have the premiums for that group disability come out of their account balance. In the event of a disability, the disability plan then pays benefits that go back into the account balance, and the amount of the coverage is tied to match scheduled contributions and employer matches, which would otherwise stop in the event of disability.

The importance of the private letter ruling from the IRS was that it defined the tax consequences of how those premiums would be treated and how those benefits would be treated. My understanding was that it was a favorable ruling, so in other words, the premiums that were paid to the LTD plan did not count as some kind of early withdrawal or taxable distribution. The benefits remained tax-qualified, so I believe that's the basic concept of that plan design.