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Session 22PD
Individual Disability Insurance Opportunities for Life Insurers

Track: Product Development

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Summary: The individual disability insurance business is alive and well. After many years of decline, the industry is now experiencing double-digit growth in sales and profits. Attendees learn about quantitative and qualitative evidence of opportunities that exist in the individual disability market, along with specific varying product approaches.

MS. ERICA MORRISON-BRAZITIS: After a decade of declining sales and negative profits, the disability insurance market is making a comeback. The economic and demographic trends of today are fueling the sales of individual disability income (IDI) insurance. Our panelists today come from various backgrounds. We have representation from a life insurance background, product consultant and reinsurer. Their presentations will focus on the reasons why life insurance carriers should have an IDI product within their product portfolio.

It's my pleasure to introduce today's panelists. Our first panelist is Steve Miller. Steve joined Disability Management Services Inc. (*DMS)* last year as vice president of business development and client services. Prior to joining *DMS*, he was vice president of life products and services at Travelers Life & Annuity. Under his leadership, Travelers' life insurance business rose approximately 40%, making it one of the fastest growing life insurance businesses over the past several years.

Our second panelist is Dan Skwire. Dan is a principal and consulting actuary in the Portland, Maine office of Milliman USA. He specializes in the areas of individual and group disability products, design, pricing, state compliance, valuation and mergers

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and acquisition. Dan is the chair of the Disability Special Interest Group and a member of the Society of Actuaries Health Practice Advancement Committee. He has authored articles for the *North American Actuarial Journal* and *Contingencies* magazine, and in his spare time he writes poetry.

Our final panelist is Andy Castillo. Andy is currently vice president and actuary at Munich American Reinsurance. Andy is in charge of Munich's individual health reinsurance lines, which include IDI and long-term care. Currently, Munich American Reinsurance is a recognized leader in new business disability reinsurance.

After our panelists have concluded their presentations, I'll accept questions from the audience. Thank you.

MR. STEVEN MILLER: We have a nice, small, intimate group here. It should lend itself to a lot of questions and discussion, maybe even debate, which would be great. Maybe one of the reasons why we have such a small group is because people thought it was a typo on the agenda. What's disability income (DI) insurance doing at a life insurance conference? When you think about it, the life insurance industry today has some pretty significant challenges on its plate, and DI can help leverage the life insurance business, open some new doors, bring in some new distribution and raise the business to the next level. I know. I was in the life insurance business for 17 of my 20 years in the insurance industry. I was responsible for Travelers' life insurance business, and the issues that we faced were simply some of our biggest markets for life insurance were under fire. The state tax confusion was limiting our second-to-die sales. Our corporate-owned life insurance (COLI) business was constantly targeted and misunderstood as janitor insurance, or perhaps looking like a nice offset to some of the tax plans. The split-dollar free lunch is over. The taxation on the annuity side doesn't look very favorable right now either.

So how do you grow your revenue? How do you grow your top and bottom line? How do you recruit producers when it's so ultra-competitive out there? How do you differentiate your products? Margins, as you know, are extremely compressed right now. How do you differentiate your products without having to cut your premium and compress your returns even more? How do you add sizzle? How do you have something new to talk about with your insurance agent? These are some of the things we hope to address with you today.

I think to best understand what DI could mean for your life insurance business, you have to understand where it is and where it's come from. I'm pleased to say, as Erica said, DI is making a comeback. In 2001 pretax margins finished at about 11% in the industry. Now, 11% for the inforce may sound okay, but given where DI had been 10 years ago, it's nothing short of miraculous. As a matter of fact, the DI industry has posted seven consecutive years of dramatic improvements in its bottom line, and those dramatic improvements were made possible only from 12 years of very bad numbers from the mid-'80s to the late '90s. It's a story worth telling, and worth understanding as you contemplate what DI could mean to your

business going forward. The lessons of the past are always very valuable.

DI is a cyclical business. It's also a business that's heavily dependent on a risk management discipline. When the industry forgets how important risk management is to driving bottom-line results, and lets marketing drive the bus without a balance to its decision making, it always gets off track. In the late '70s and early '80s, DI was very profitable. Interest rates were high, so investment income was favorable. Inflation was high, and there weren't aggressive cost-of-living-adjustment (COLA) riders, so replacement rates weren't very high, and there was a lot of motivation to get back to work. DI was a profitable business to be in, and companies were flocking to the business because of its growth potential and economics.

The problem was the industry forgot the risk management discipline and took the leap-frogging approach where every company copied the product-plus-one liberalization. Before you knew it, products were ill designed with weak contract language, own-occupation definition, lifetime benefits, open-ended recovery benefits and residual benefits and aggressive COLA riders. More importantly, they forgot one of the key aspects of a risk management discipline, and that's diversifying occupational risk. The industry went so heavily toward the medical professional field that when the socio-economics of that field changed to a managed-care crisis, it was ill prepared to sustain the volatility. The problem was everyone was writing doctors and dentists. Doctors and dentists were losing income because of the HMO controls and the increase in malpractice insurance, and they found themselves insuring just about 100% of their income with a pretty liberal contract that would allow them an early retirement. So the claims came in, the numbers looked bad, and at least 40 of the 70 carriers in the business got out. They got out quickly, and it was an ugly situation.

The carriers that stayed in DI rolled up their sleeves and went about fixing the problems. They raised their premiums; they tightened their underwriting; they sharpened their contract language; and they invested in their claims management practices, bringing in medical resources, psychiatric and investigative resources, and they managed the business in a smart way. And finally, year by year, the fundamental economics of disability improved. The industry hit rock bottom in 1994 and then started to climb out of it. Results for 2002 should be compiled within the next month. We're optimistic based on feedback from carriers that 2002 was a good year and a continuation of a positive trend, but to bring the inforce from a negative 16% margin in 1994 to a positive 11% margin in 2001 took a lot of hard work. So the fundamental economics of the business are much better today than they've been since 1980, almost 25 years!

Not only are profit margins restored, but reserves have been stabilized. The tighter underwriting, the longer elimination periods and the settling out of the managed-care crisis have led to an improvement in claim incidence. We're enjoying two years of double-digit growth. Sales grew 11% in 2001, and 14% in 2002. Probably the most encouraging news is if you look at the demographic trends of today and those

trends that are expected to continue in the future, you see that there is a huge need for DI. The way I size up the viability of a business is, if people need it, if people don't have it, there should be a way to deliver it and deliver it in a way to make money.

Take a look at the market penetration for DI. The industry's done a great job of writing doctors, dentists and lawyers, but they've left virtually the rest of the working population unattended to. With penetration rates below 10%, corporate executives, professionals, managers and middle-income employees barely have DI. If you roll the whole thing up, 2.5% of working people have IDI protection, and somewhere between 25 and 30% of working people have group long-term disability (LTD). LTD typically protects about 60% of income and typically does not cover bonuses, so you have 75% of your workers with no disability protection; you have 25% with some but perhaps an inadequate level of protection. That's what I call a very underpenetrated market.

One of the reasons the market is underpenetrated is there aren't a lot of carriers out there selling DI, and there aren't a lot of producers out there selling it. If you look at how concentrated the industry is, the top 10 DI writers make up 90% of new sales today. Contrast that to the life insurance industry where the top 10 make up fewer than half of the sales. So it's a very concentrated business. In the upper end, white-collar professional, in the large multilife employer-pay market where you have 100% participation, I'd say the industry is pretty competitive today. All other applications are very underserved: there's very little penetration.

One of the reasons we expect the demand for DI to increase is the fact that people today, and in the future, are more vulnerable to a loss of income, and they're more vulnerable for three reasons. One, compensation today is more geared towards back-end performance-related bonuses, bonuses that aren't typically covered by group insurance. You come off a couple years of bad bonuses, and you may be ill prepared to sustain a period of LTD. To sustain a period of LTD, you need liquid assets to cover your expenses, and if you look at household assets today, they've changed dramatically from where they were 20 years ago. Twenty years ago, almost 20% of your assets were in liquid bank accounts. Today, 20% of your assets are in stocks. Can you liquidate stocks? Sure. Is it a good time to do it? No. At the same time that your assets are more volatile and your income is more volatile, debt is at all-time levels. If you look at household debt as a percentage of disposable income, at 14%, it's up quite a bit from where it was 20 years ago.

There have been some shifts in the demographics of employment as well. By 2010 almost 40% of the workers in America will be over age 50. These are people that are finding, "I have to work a lot longer before I retire than I thought, because the assets I was hoping to retire on are worth a lot less since the market correction." These workers in their 50s are very vulnerable to a loss of income, and they're very susceptible to an LTD. So you have a growing need in the work force from that aging group of workers to protect themselves from a sustained loss of income. At

the same time you have some younger workers joining the work force who are increasingly mobile. As a matter of fact, today Americans are averaging three different careers and 10 different jobs, and that's going to increase. So portability of benefits is going to be more and more the focus of employees as they select their benefits.

As they select their benefits, they're facing an environment where benefits are voluntary. You have to pay for them yourself. Health-care costs have escalated so much that when you look at total benefits, it's almost one-third of total compensation versus 10% 30 years ago. So how are employers dealing with this? Quite simply, they're pushing some of the costs down to employees and making benefits available on a voluntary, employee-pay basis. When I bought my IDI policy, it was triggered by my employer saying, "I'm not going to pay your LTD premiums anymore." Well, once it became my money to buy my benefits, I wanted a portable policy with a strong disability definition; I wanted the best coverage I could get. I went out, and I bought an IDI policy. And I think as more and more employers make DI something that you pay for yourself, IDI is going to be something that's going to be considered.

I hope that I've convinced you that the economics have vastly improved for DI and that the sales opportunities are plentiful. I wanted to share with you my thoughts, if you are going to get into the DI business, what attributes should you be looking for, what are the attributes of a good market opportunity? I think it starts with principle number-one in risk management for DI: Spread your risk. Get a good, diverse slice of occupations. I really believe it's infinitely easier to predict incidence of injury and sickness than it is to predict motivation to go back to work, than it is to predict socioeconomic changes or shifts in our society 10 and 20 years down the road. So having a heavy concentration in any one industry may not be a prudent thing to do.

Low acquisition expenses: everyone knows DI is governed by minimum loss ratios, so getting your arms around your expenses is a way to maximize your profit margins. I like markets where there's not rigorous underwriting, not expensive underwriting: multilife opportunities, ancillary sales. Selling DI when you're selling a life insurance policy is a very efficient way to cover those underwriting expenses. I like markets where there's reduced motivation for being selected against, where the DI benefit is small compared to the other products that are also being sold, so it's not their primary motivation. I like markets where there's limited competition, and, as I've mentioned, that's a lot of markets in DI these days and obviously markets where there's ample opportunity, ample customers who need the insurance and don't have it already.

There are a couple of markets for you to consider. Banks, I've found, are increasingly interested in selling DI, especially to wrap around their mortgages. When you think about their motivation, they want those mortgages to stick, and they want the payments to be made. With any customer who buys mortgage DI, the bank is deepening that relationship, increasing its persistency and diversifying

its revenue stream. DI as a rider on life insurance: we've talked to companies that are desperately looking to differentiate their term insurance. Term is the ultimate commodity product. Whether you're a reinsurer or whether you're a direct writer, you know what the margins look like. Being able to combine a life sale with a DI sale has a lot of sizzle and can provide some differentiation that gets you off of: "My rate is $10 cheaper than the next company's rate."

Finally, wrapping retirement plan contributions is gaining more and more attention. There's such a huge pressure on us to save for retirement, and obviously the biggest risk during your working years is having that income continue to come in so you can put money away for retirement. Wrapping your retirement plan contributions around DI is an excellent way to protect against your biggest risk. Middle-income market: I love it. There are not a lot, but there are several companies out there that consider themselves financial planning companies for middle-income families, but they're not offering DI. So, they're not offering a solution to the biggest risk their customers face. I think a simple strip-down product with an easy agent-friendly underwriting process that provides basic catastrophic coverage is an excellent solution for middle-income earners. Let's face it, when most people don't have any disability coverage, if you can provide them some basic catastrophic coverage, if you can provide a solution to the masses, you're doing the industry a great service.

Finally, on the voluntary benefits side, whether it's an executive carve-out or a worksite marketing product, I think this is going to be a big marketplace. DI has shown itself to be one of the more popular voluntary benefits. If you have a work-site marketing operation in your company and you're not offering DI, you're missing the boat on one of the most popular products to insert there.

Benefits to new entrants: I think this is somewhat obvious. It's a new source of revenue and profit. It gives you something to talk about in your recruiting strategy, and recruiting is so ultracompetitive these days. It gives you a chance to get into new distributions, whether it's banks or producer groups. I have news for you—the big producer groups are hungry for DI solutions. It completes the financial planning process. If you call yourself a financial planning company and you don't have DI, you're not. It facilitates cross-selling. When you sell DI, you're talking to someone about their cash flow; you're talking to them about their expense replacement needs. Life insurance is a very logical cross-sell product when you're in there selling DI. The economics, I said, are good, but there's some risk associated with that. You're going to hear Andy talk about some prudent risk management strategies to avoid some of the pitfalls that the industry has seen over the years.

So if it's so great, why aren't more companies jumping in? Well, there are some serious challenges. It's not an easy business to get in because it's somewhat specialized and somewhat complex. Because it's so dependent on risk management, you need very good people in claims, you need good people in underwriting, and you need good people in actuarial. There are not a lot of DI

people out there, so getting good experienced staff is a challenge. Some sort of partnering approach where you have holes in your skill sets may make sense to achieve that end. You have some systems requirements. Not only do you need to integrate your claims and your administration systems so that you properly police the contractual benefits of your policies, but you need to track your business. You always have to be slicing and dicing and evaluating by your experiences emerging, because proactively taking action is the key to avoiding big problems down the road. Finally, because you have a fairly big investment up front, if you don't outsource, critical mass is difficult to come by. You need to sell a lot to get to that critical mass stage.

I'm going to wrap up with just some general challenges for the IDI industry in total, not just for new entrants. There is a huge need for this insurance, but today the need does not directly translate into demand. People don't know that they need DI. It's one of the most misunderstood risks out there. The American Council of Life Insurers (ACLI) just surveyed a number of small employers and asked them what they thought the risk is of becoming disabled on a long-term basis, and the majority checked one in 50. The reality, folks, is the risk is one in three. So that's a gross miscalculation of the risk.

The industry needs to do a much better job of marketing what the real risks are and educating people about how they need to protect themselves. Part and parcel with that is they need to get the producers back that fled for the hills when everyone got out of the industry. Let's face it, the industry made the product so complex with so many bells and whistles applicable and attractive only to the wealthiest of professions that it turned off many producers, and we need to get them back. We need to get them back with designs that are affordable, designs that provide basic protection for many people in an agent- and customer-friendly manner. We need to get more carriers in the business, because it's only when there are more carriers and more competition that innovation and the high standards of excellence on the service side truly emerge.

We need to continue to create new applications for DI, and there are a lot to be created out there. Most importantly, we need to remember the lessons of the past that led to all the problems that took seven years to fix. Thank you. I'm going to turn it over to Dan, who knows much more about DI than I do and is going to present some creative ideas.

MR. DANIEL D. SKWIRE: We're going to talk today about a variety of different approaches to the IDI market. This is not a one-size-fits-all proposition for this market. I wanted to start out with a reminder of a couple of the points that Steve mentioned in his presentation. Why is it an attractive idea for a company not already in this market to enter the IDI market? There are a few key reasons. Clearly, I think there are growth and profit opportunities. You've heard him talk about the dramatic recovery in profits in this business. And that recovery in some ways understates what's going on, because he depicted the traditional, generous,

noncancelable, white-collar IDI products, the ones that suffered the most, but there are all kinds of other offerings out there. IDI products are a perfect opportunity as well to leverage your distribution if you have financial planners and agents and brokers who are sitting down face to face with buyers of insurance and talking to them about their financial needs. What a perfect time to have a product connected to income protection to talk to them about. So much of the market is focused on asset protection, but a big part of the financial picture is protecting income, and that's exactly what this product does.

Along the same lines, IDI is a method to broaden the offerings to your current customers. This isn't necessarily prospecting out of the blue. There's a tremendous opportunity for new business on existing customers here. The message is that no matter what kinds of products your company sells now, and no matter what methods you use to sell those products, there's some form of IDI offering that's going to be a good fit for your organization.

At the same time I guess we could say that no matter what type of disability offering you have, there are a few things that are always going to get you in trouble if you're not careful, and I wanted to mention some of those right up front. One is being a little overly infatuated with the top line. It's not hard to put a ton of premium on the books in a very short period of time in this market. We've seen it done in some situations through price concessions or through backing off on underwriting. Steve mentioned competing a little too heavily on the generosity of the product features. If you take steps that are too dramatic in these directions, in order to chase the top line, it will catch up with you on the bottom line.

Going along with that, taking short cuts on the underwriting side can be tempting. DI in many, but not all, forms is very complicated to underwrite. You have to get a lot of information, and it's very tempting to say, well, we're going to simplify this and streamline that and make it quicker and easier. They're admirable goals, and they work well if the product is designed to support it, but if not, if all you're doing is giving up the information you need in order to sell a complicated product of course, you can get into some trouble.

Claims management on disability is a very different discipline than it is for other insurance products. Disability claims are very long. You need to get a lot of medical information; you need to get a lot of financial information, periodic reviews, checkups, discussions with physicians, etc. It's not a customer service function, and it's important to pay the right level of attention to claims management.

Finally, I think some companies have been caught by surprise when something happens with their business, and they find out that they don't have the appropriate amount of data, or they don't have the right kinds of experience studies set up to help them understand what's going on with the business and to help them identify the solutions that are necessary to keep it running profitably. Because of the complexity of many disability offerings, you need to capture a lot of different kinds

of data to understand the business.

For the rest of this presentation, I'm going to focus on some very specific approaches to the IDI market. For each one I'll give a brief definition of the approach. I'll mention some of the keys to success and some of the pitfalls that can be experienced in trying to participate in these market segments. And finally, I'll give a brief profile of the kind of organization that I think would be successful for each of these offerings, because I think clearly not one approach works for everyone.

Now, the first approach that I want to mention is the traditional IDI offering. It's an income protection product. It pays a stated monthly indemnity that equates to a percentage of your income, and it's sold on a one-to-one basis in the same manner that individual life insurance might be sold. When done successfully, it's a needs-based sale.

In this market, as Steve mentioned, risk management is essential. Of course, underwriting is a primary consideration in the individual life market as well. But it's even more challenging for IDI, because there are many conditions that aren't material from the purpose of evaluating mortality risk, but that have some very significant implications for disability. For example, a bad back, a bad neck or certain kinds of psychiatric conditions may have very little impact on mortality but could lead to very costly disability claims.

In addition, experience analysis is very important. And one of the tricky things about experience analysis in disability is that sometimes if you're not looking at the business carefully, it can take a while for trends to show up, because a lot of the cost of claims is kind of buried within your estimate of claim reserves. If your assumptions on those estimates are wrong, it could take a while before that actually turns up, and you can see what's happening with your business. There are all kinds of techniques for handling this, but it's important to get the right ones in place and to look at them on an ongoing basis so that you can understand what's happening with your business.

Some of the problems that companies have when they get into the IDI market involve trying to take a little too quick a start. Often that happens by competing a little too aggressively, by trying to take short cuts on the underwriting side, or by copying someone else's product but with a 10% lower rate and assuming that everything is going to work out correctly. I think this is a business that rewards a well planned and diligent approach. It's worth building up an infrastructure and systems to be able to support this business and to begin to get a feel for what's involved in underwriting and paying claims before you get too far in.

I think that the best profile for a new entrant into the IDI market would be an experienced life insurance company that really is comfortable with the concepts of risk management. A company that prides itself on its underwriting, for example,

and is a company that will be able to embrace the kinds of analysis and work that's required on claims management.

The next approach to the IDI market is the multilife IDI offering. If this sounds unusual to you, you're not alone; it's a bit of an oxymoron to talk about a multilife individual offering, but, in fact, this has proven to be a very effective way to sell IDI insurance. It involves trying to sell policies to a number of different individuals at one time through an employer-sponsored offering. In many cases you'll see these kinds of offerings in tandem with a group LTD plan. For example, you might have a group plan that has a fairly low maximum benefit, and maybe the company has a population of managers or officers or more highly compensated employees who would like to be able to purchase a higher level of income protection. Rather than raising the maximum on a group plan, which can have some cost implications, the company will instead put together an employer-sponsored IDI offering to provide coverage for that carved-out group of higher earners.

This description sounds almost like a combination between group and individual insurance. In fact, you're issuing individual policies, but the fact that you're selling it to multiple employees at one time sometimes means that you can begin managing and underwriting the business using some group techniques. For example, if you have a clearly defined class of people to whom you are marketing these individual policies and you're able to get a very high participation rate, 100% if the employer's paying the premium, or maybe 50 or 25%, then you may be able to begin using some simplified underwriting. That has some very attractive aspects to it, because it can simplify the issue approach to the business and get some more premium on the books. And if it's done in a manner that is consistent with the principles of group insurance, which is that you're getting enough lives and enough participation, this can be a very profitable way to write individual policies.
Some of the success factors in this business include a good knowledge of the group business, particularly so because these offerings are so often packaged with group LTD. Likewise this offering is most common in white-collar markets and is usually a brokerage offering rather than an agency offering. That doesn't have to be the case, but agents tend to be a little more comfortable with a one-on-one sale, and there are certainly a large number of brokers who specialize more on the benefits side and are going to be a little more comfortable with the group coverages.

Areas where some companies have trouble include getting a little aggressive on the underwriting offers. I mentioned that for those group underwriting techniques, it makes sense only if you're really dealing with a group kind of risk. If you're just getting five lives out of an employer population with 200 lives, then I probably wouldn't recommend going in there with too many underwriting concessions. That really feels like an individual risk, and it should be underwritten accordingly.
Another thing you have to watch out for is there is some competition out here now, just as there is in the group LTD business, where there are multiple offers coming in, and the companies are kind of bidding cases around. And if you're a new entrant here, you want to make sure that you're setting up your rules and kind of sticking

to your guidelines and not getting too caught up in the bidding wars until such time as you have a little more solid understanding of the business and how it's performing for you. The kind of company that's likely to succeed in this market would be a life company that has some good brokerage relationships and that has some experience in the group market and working with employers. That's very important in this particular segment.

Now, one of the approaches to the IDI market that Steve touched on briefly in his remarks consists of offering DI as an adjunct to a life insurance policy. Probably the most common way to do this is to have a DI rider on the individual life policy. I'm not talking about a waiver-of-premium rider here, although there can certainly be connections. I'm talking about something that actually provides a monthly income benefit. You could connect it with a waiver rider; I've seen riders that cover both at once. The rider both waives the premium for the whole life offering of, say, the target premium if it's a UL offering and, in addition, provides some monthly income, so it can certainly get tied together. There are also other ways to tie it to the life insurance policy more closely. I've seen some that have links between the benefit amount of the life policy and the monthly income benefit on the disability. One of the keys here is to make sure that you keep the design simple. One of the reasons this kind of offering is attractive is because it's an easy way to get agents who are comfortable with life insurance to start selling some DI. If you start rolling out too many bells and whistles, you might find they lose interest kind of quickly. I would certainly suggest keeping this kind of offering as an add-on product to the life channel and trying to focus on simple design and some very clear training for the agents on how to sell the need and how to make the connections as simple as possible.

One thing to remember on these offerings is they are still DI offerings. It's a rider on a life policy, but it's still insuring a very different risk than the life policy. You still have to keep in mind some of the risk management considerations that we mentioned for traditional DI offerings. You still need to ask if the person has a sore back before you can issue it, and it may not be a question that's already on your life application. Sometimes, for example, if you're rolling out this kind of offering, you'll have to have a supplemental health questionnaire with a few extra questions. I think this is a good fit for a life company that has an agency kind of distribution in particular. It would also work with a brokerage distribution, but I think this is a nice way to transition life agents into selling some DI business without sounding like you're asking them to learn too much new stuff at one time.

Mortgage DI offerings, I think, also present some potential in this market. What I'm talking about here is not a credit DI offering. A credit DI offering is something that's going to be sold at the same time as you purchase the mortgage. It might have a single premium, and it's probably going to have a benefit period that's connected exactly to the loan, so it will be sort of a declining balance where the benefits will run out exactly as the loan does. What I'm talking about here is another method of marketing a simplified IDI offering, but doing it in the context of helping someone

with financial planning for what would happen to mortgage payments in the event of disability The primary links here are that the amount of the policy is going to be equal to the amount of the total mortgage payment, and the term of the policy, while probably not exactly matching the mortgage, is going to be in this short-to-medium-term range. You see a lot of these that have a five-year benefit period, for example. So it's not necessarily running out for the entire remaining term of the mortgage, but it's providing kind of a medium level of protection there.

Once again, these kinds of coverages need to be managed similarly to a traditional IDI policy. They do require underwriting and claims management, though in this case, because you are issuing relatively low dollar amounts of coverage that often means that you can keep the underwriting requirements somewhat simpler. Typically those amounts are going to be below blood-testing limits or medical-exam limits. Companies have different strategies on these kinds of things, but often if you're selling policies of $1,000 a month, the lab tests are of less importance, so that can help simplify the process a little bit. You do need to keep an eye open for overinsurance here, and be sure you're asking questions about what other types of income protection the buyer has. If you're selling to someone who already has a group plan that covers 60% of his income and an individual plan that covers a little bit on top of that, he probably has enough money coming in, in the case of a disability, that he's going to be able to pay that mortgage payment and may not need the additional $1,000 or $1,500 of coverage on top of that.

This is really an individual sale, so it needs to get the appropriate underwriting attention, and you need to give your agents the appropriate training about the value of this coverage so they can communicate it to the buyers. When done successfully, I think this is a very interesting kind of offering, and I think for any life company that's comfortable with the risk management issues involved in underwriting the coverage and is comfortable in talking with buyers about longer-term financial planning issues, this is a very successful kind of offering and one that can be rolled out without too much difficulty.

Well, now we're going to talk about one that's a little more complicated. Retirement savings disability products have actually been getting some attention lately. There was an article in *National Underwriter* about a week or two ago that talks about a few examples of these types of coverages. These are designed to cover a very specific need, and that is when a person becomes disabled, in addition to the normal income that they're losing, they are probably losing the ability to be able to make contributions into their retirement plan to provide them with income after retirement age, and they are probably losing any matching contributions that they would have been getting from their employer during that time period. So these plans are designed to replace both the employee's contributions into a defined-contribution kind of plan, as well as the employer matches. There are a whole variety of different structures here. Some of these will pay into the actual retirement plan. I think that is actually most common with group benefits, rather than individual, but there is actually a way now to embed group LTD coverage

within a 401K plan, so it's seamless, and everything remains tax qualified.

The more common individual model is to have benefits paid into some kind of trust that allows for a deferred receipt of the income by the individual. In other words, you don't want to just pay this money directly into the hands of the individual where you're kind of creating an overinsurance issue, because they can go spend it on something other than retirement.

The keys to success here include being able to explain the need and the advantage of these coverages. You need to understand the tax implications. That's very important because that's going to be different for every different product structure. You need to avoid overinsurance through the use of these deferred kinds of vehicles, whether it's an annuity or a trust or a retirement plan. And to market it successfully, I think, it's helpful to position it as an alternative to a lifetime DI benefit. That was kind of the old method for covering this risk, but it proved to be one where companies lost a lot of money because a lifetime benefit is a difficult risk to manage. Doing it through a form of retirement savings, I think, makes a good deal more sense.

We mentioned understanding the regulatory and tax issues and product complexity as being important considerations. I think the kind of companies that succeed with these products are life companies that are comfortable with asset management that have an annuity business, or that are used to dealing with employee benefits and working through some of these more complicated situations.

Now, to change gears a little bit, we'll talk about some offerings that blur the lines between group and individual coverages. Work-site disability is a way of offering individual coverages at the work site through the use of very simple products that are paid for by the insureds through payroll deduction. Usually these products are stripped down and simplified and, while they are medically underwritten, are designed in such a way that the medical underwriting process is not too intrusive. The keys here are keeping the product design simple. You're going to try to persuade people to enroll in this coverage through some very quick group meetings or some presentation materials that you hand them, and they need to be able to understand it quickly and see the benefit. Also, the design of the product itself is very important here, because your goal is to keep things simple, to be able to explain it simply, to be able to underwrite it simply, and to have the insured clearly be able to see the value of it. So through the design of the product that you use, through the exclusions, through the benefit formulas, through the definitions in the policy, keeping it simple will really make things work better.

Things to watch out for here include doing too much guaranteed underwriting. If you're going to do guaranteed underwriting, make sure it's really a group risk. Don't assume just because you're getting a few lives at once that it qualifies for guaranteed standard issue and no medical underwriting. In addition, these policies can sometimes be subject to low persistency. They're often getting sold to lower-

income folks, blue-collar or middle-income markets with less disposable income or with higher employee turnover, and you need to watch out for the persistency and make sure it's not causing you problems on the expense side, for example.

Companies that succeed here tend to be those that are good at marketing and that have a broad product portfolio. Disability is often just one element of a suite of work-site products, and companies need to have a good technical platform to manage the business and to support the enrollment. Getting a high level of enrollment is crucial to managing the risk on these offerings.

Association and affinity disability products are another interesting segment of the IDI market. By associations I mean professional associations, so it's a group of people who all are in the same profession for different employers, such as the Kentucky Medical Association or the New York Bar Association. Affinity groups are people who are affiliated for any reason, other than their employment, so it could be anything from the American Automobile Association to an alumni club or the customers of a bank or a retail organization. Often these policies are sold on a conditionally renewable basis, so you can keep them in force as long as you're a member of the organization, but if you leave the organization, the coverage may go away.

The key to this market is that you need to manage the risk as if it's an individual policy, but you need to manage the case as if it's a group policy. That means when it comes time for renewing rates or communicating things to the policyholder or working with a broker, you need to understand you're dealing with one big case, all of which can kind of come or go or move around at one time. These cases may be bid out to different insurers, for example. That's a dynamic individual companies might not be used to, but it's common on the group side. Sometimes you can get into trouble if you try to compete too much against the individual plans by offering really generous benefits or complicated products in order to make this more attractive. It might seem like it makes it more attractive, but sometimes it doesn't. Sometimes what's needed is really a simpler kind of offering. You're trying to get the customers who don't have easy access to other types of coverage. Finally, beware of overconcentration in certain occupations: if you're writing only medical associations, you can get very high concentration of risk in your block of business if you're not careful about how you manage this kind of stuff. The kind of company that succeeds here is one that's comfortable with both individual and group kinds of businesses. It really takes both skills sets to succeed here.

The last two offerings I'm going to talk about are similar in a lot of ways, and they're really the simplest when it comes to product design. Direct marketing offers refer to those that can be sold through the mail, for example, or over the phone or even on the Internet. Sometimes these are truly direct right from the company to the buyers through some work by the company's own staff. I think more commonly they're sold through a marketing organization of some kind that is experienced in doing this kind of marketing, so a company might team up with a bank to offer

coverages to the bank's customers or a retail institution, for example. Here we're really talking about the simplest possible product design. You're going to try to get your message across in a sixty-second telephone conversation or in one little trifold brochure that's enclosed with a credit card bill. So you need to have a very clear and succinct message and not too much small type here that someone's going to fail to understand. You try to maximize the response rate, so you need to get the message across clearly, and you need to have the right price point for the product. I worked with one company on one of these, and they told me, "You know, it really doesn't matter what kind of benefits this contract pays, but it has to cost $9.95 a month." You go figure out what we can put in a disability policy for that." So it's a little different approach to the market, but it's really important to know that kind of thing. Don't assume people are comparing disability benefits if all they're thinking about is how much disposable income they have to spend.

As with most other inexpensive products there is some fixed cost pressure here, and if the response rates get too low, you're putting a lot of money into the mailings and not getting it back in terms of premium. So you need to make sure that you're looking at all the components of your expenses here very carefully when you design these offerings, from response rates to persistency to compensation expenses. What's needed to succeed, is the superior marketing aspects of the organization. Whether that's your company or whether it's a partner you're teaming up with, the product should be designed to be simple and to keep the risk levels low, and what you need to make sure you can do is communicate the benefits of the product and get the thing sold successfully with high responses.

The last one I'll mention today is accident-only insurance. There's a lot of overlap here with direct marketing because this is a product that is frequently sold through direct marketing. It's a product that pays a short-to-medium-term monthly benefit only for disabilities due to accidents. It has the advantage of requiring no medical underwriting. A lot of times accident-only disability is included in a whole package of accident-related benefits. It might be sold along with accidental death and dismemberment, hospital indemnity coverage, emergency room coverage and specified injury kind of events, so a lot of things can get fitted together, and by adding or removing some of those it can help you hit some of your price points for this business.

You do still need to manage the claims on this, though. It cuts back on the underwriting, but the appropriate attention to claim management is important, and as with the direct marketing products you do have some issues around low persistency and distribution-related expenses. So you need to make sure that whole financial picture comes together successfully for you.

Once again, we're talking about a superior marketing organization in order to succeed in this kind of business. This is a great solution for companies that don't have a lot of tolerance for underwriting or for a life insurance company looking for a very simple offering that will begin to get them into the disability arena, but isn't

quite ready to make the full investment into an IDI offering.

That completes my brief tour of the IDI business. The important message here is there are a lot of different approaches to this market, and the key is to look at your own organization, figure out what you do well, what products you sell well, what you understand, what the strengths of your organization are and to find a disability solution that fits with what you do best. Thank you.

MR. ANDRONICO LUCAS CASTILLO: Let me give you some background on how Munich American Re got into the disability reinsurance business. As you all are aware, I'm sure, Munich American Re is a wholly owned subsidiary of Munich Re. Our offices are in Atlanta, and our core business is really life reinsurance. I think as early as mid-'80s, the company started thinking about how to diversify its businesses, but we're a professional reinsurer, so to some extent we are limited by our mandate from Munich Re. We are to do reinsurance business only, and we are to do reinsurance business through U.S. companies only. In any event, life reinsurance, as you all well know, is just as competitive as on the direct side. So back in the mid-'80s, we started looking at other lines of business. In fact, there was a team in our company called the DI team. The DI really didn't stand for disability income. After a while it stood for the "Do It" team. The problem with that was that we all thought it was a good idea to get into the business, but then during the mid-'80s and early '90s, competing with the big reinsurers or the established reinsurers in DI, looking at the products that were available, looking at just the whole thing, it seemed not to be the right time to do it, so it was a matter for us to have a wait-and-see attitude as to doing DI.

We actually started doing disability reinsurance probably in the early '90s, but we concentrated on the non-white-collar marketplace, the blue/gray-collar market, the lower amounts and stuff like that. But by definition of reinsurance and by the very nature of the gray market, really, the production that we achieved on doing that type of reinsurance was fairly minimal. In the mid-'90s, as the reinsurers then were also losing money, as much perhaps or more so as the direct writers, they pulled out of the reinsurance marketplace, and we saw that as an opportunity to get in and do disability reinsurance. Now, one thing I should say, though, is that we concentrated on doing disability reinsurance on a new-business basis only. We intentionally shied away from inforce blocks of business for some of the obvious reasons and the way it was underwritten.

At any rate, that's a little bit of background of where we are with disability reinsurance. We still think too, from our perspective, that IDI is a promising market opportunity. Steve gave a lot of good, convincing arguments and statistics that it is a promising market. For one thing, the DI product really meets a basic consumer need, so it is a fairly viable product. Dan gave us a lot of ideas and probably could have given a lot more as to how you can get in and develop a DI product. I think as Steve showed earlier, many companies have lost money in the past and withdrawn from the market. I think Steve showed the pre-tax margins. Just to let everybody

know, even post-tax is fairly similar and consistent. I think the industry started showing some good results back in 1999.

I think what's not really been mentioned, and probably is in everybody's mind, at least we suspect so from our end, is that a lot of the reasons why the results are good are perhaps because of the new business that's being written. We think that the new business being written is really quite profitable. It's probably somewhat evidenced by the fact, even from our end, that the business that we write, which is really just new business reinsurance probably dating back to 1998–99, is really quite profitable for us. We have a guarded optimism that it continues to be as such.

From our standpoint, one of the philosophies that we follow is that since we got involved with disability reinsurance, we've never really concentrated or we've never really had a focus on market share. The focus has always been on reasonable, profitable growth. In fact, frankly, we really don't have any real growth targets that we have to meet: It's really all about the bottom line. That being said though, then our focus really is to ensure that the business that we put on our books is written sensibly. We think that there's competition out there, but we think it's sensible competition. If you look at the products being written, if you look at the rates, the underwriting and the claims management, they all seem to fit in quite sensibly, quite well. We're still fairly optimistic that the business being written currently is quite profitable.

I think the message that I want to say today is that if you're going to get into this market, you have to keep in mind that the basic risk management tools are in place. We have to keep the right tools, the right designs to make sure that you stay there for the long run.

Let me talk about some of the basic risk management essentials—nothing really fancy, I just want to get back to basics. The basics here are identifying the risks, and I'll concentrate the rest of my talk on the risks that are specific to DI, which are really the incidence risk, the claim continuance risk, persistency risk, the payment risk, investment risk, expense risk and a combination of some of these risks. And there are other risks that I'm not going to discuss today but that I'm sure you can come up with. There are operational risks that you probably need to think about. There are legal and regulatory types of risk. There actually could be risks that are unique to your company's situation. I know when we were looking at it from our viewpoint, there were some unique risks from our standpoint that we had to address.

After you identify the risk, then, of course, we need to quantify the risk, and I will give some examples again, fairly basic, coming down to the basics of what the magnitudes of some of these risks are. Then after we quantify the risk, we need to figure out whether we want to accept that risk or what we want to do with that risk or what would have been an appropriate response. What type of risk management designs can we do? By that we mean perhaps we can ameliorate some of the risk

through product design or with a combination of underwriting guides or underwriting guidelines in combination with a product design, or when you're looking at your processes, or if you have the right resources—it could be really just about anything.

In any of these situations, by the way, I think it was mentioned before that there's not really a lot of expertise out there, but there are quite a lot of outside experts. You have the consultants, the specialty service providers and the reinsurers. Other than us, Cologne also is in new business reinsurance, and I think there are probably more reinsurers on the LTD side of the business, even though we concentrate on the IDI product today, but again the risks are some of the same.

We get back to the basics, the incidence risk, which is really the risk that too many people incur claims. I thought I'd just do some fairly basic calculations, and show what the impact is using a male, CIDA class one, up-to-age-65 benefit period with a 90-day elimination period. This is probably too obvious: what's the impact on premiums of a 10% increase in incidence rates? Just to get a feel for what the incidences are: The incidence per 1,000, say, at age 45, according to CIDA is about 3.35 per 1,000; the incidence of sickness is about 2.7 per 1,000; and the incidence of an accident disability is 0.65. Just to give you an idea, it's about 3.35 per 1,000 in total according to CIDA. If you compare that to the latest SOA 1995 mortality experience study I think what I saw was that the select rate at age 45 is 0.72 per 1,000, and the ultimate rate is 2.5. So we're talking about incidences that are really higher than the mortality rates, and it gives you some idea of the premium levels should be.

One of the ways that we can manage or respond to the incidence risk, of course, is proper medical underwriting. Another would be in terms of setting reasonable replacement ratios. I think we heard earlier about overinsurance. That's a very important underwriting tool. Another is product design, and perhaps offering only longer elimination periods. Or another way is really to have more conservative benefit triggers through the definition of disability. In DI, the definition of disability is very important, and, you know, two seemingly similar definitions can give you very different experience. I think we've heard about a definition of "pure own occ" as opposed to just "own occ". That would get you a very different experience pattern.

The claim continuance risk: that's the risk that too many claims last too long. Again, I'd just like to give you some idea about the impact on premiums of a 10% decrease in claim termination rates. That's a uniform 10% decrease in all durations, and it's about in the seven- to eight-percent range. Again, this is to give you some idea what these claim continuances really look like. After 12 months of disability according to CIDA (the latest, CIDC) you have about 55% of your claimants still on claim; after 24 months you have about 41%; after five years you have 30%; after 10 years you have 20%. Some of these claims can really get quite long if you have 20% after 10 years.

In addressing claim continuance risk, what are the appropriate responses? Well, one is limiting the benefit periods. Clearly we see that in a lot of products available today. The lifetime benefit periods available 10 or 20 years ago are much rarer today, and in response to that, I think, are some of these retirement-plan-type designs, really in response to replace those types of benefit periods. Again, a reasonable replacement ratio is limiting your benefits due to MNAD—the mental, nervous, alcohol, drug-type provisions and self-reported limits. In essence what it does, if the claim is due to mental, nervous, alcohol or drug dependency, then the benefit period is limited typically to two years. Of course, proper claims handling is very crucial in keeping your claim continuance within expectations.

Next is the payment risk. What we mean by the payment risk is really risk that the average payments are higher than expected. The response to this really is careful design of the residual and partial benefits that are fairly common in today's contracts. The next risk is the persistency risk. It's essentially the risk that too many policies lapse and we're unable to amortize initial acquisition expenses. The impact on premiums when there are no lapses in the ultimate really is quite minimal. The main point is that toward the end of the coverage period, you have level premiums but increasing morbidity.

FROM THE FLOOR: What is the select period?

MR. CASTILLO: I think it's only about three or four years. Appropriate responses to these, well, you want to keep the richness of benefits in check. I think we see that now in today's environment wherein actually in the inforce contracts, really nobody's lapsing those benefits. It's basically because they cannot get it from anywhere else.

Investment risk is a pretty significant risk in DI. There is no risk of disintermediation. A level premium plan to 65—there are a lot of assets that accumulate in this type of product. The responses would be the possible hedging strategies—you know, you really need to look at what your investment income assumptions are, and you really need to be ready to re-price as needed. In today's low-interest environment, I suspect some of the products out there are probably underpriced in terms of the investment income assumptions that were used. That's probably also applicable not just in DI, but in a lot of other types of products as well.

Expense risk is the risk that actual expenses are higher than expected. Again, the responses to that, especially if you're starting in a new product line, are really to look into outsourcing. Combination-type risks are the risks that some of these events occur simultaneously. You know, examples are economic downturn associated with low investment return and incidence increases or periods of high inflation associated with COLAs. I think so far right now we haven't really seen —at least not to my knowledge, even with the economic environment we're in—the incidences really spiked up yet. Possible responses are obviously nonguaranteed

rates; you know, not having a noncancelable product is a possible response, but there are implications to doing that.

Anyway, I'd like to close and say that there are risks. We need to stick to the basic fundamentals of risk management, and it could be mitigated through appropriate policy design, underwriting claims, and via external resources if need be. Anyway, I want to open it up for questions.

FROM THE FLOOR: I'm interested in the 10% increase in incidence rates you showed and the approximate 10% effect on premiums. Coming from a life insurance background, that's very foreign to me, and I'd like to understand better how that might exist. I mean, you have expenses, and I would assume there are commissions to be paid as well. Why would that be? In the life insurance business for 100% increase in mortality, we certainly wouldn't see a 100% increase in premium.

MR. CASTILLO: It wasn't really a straightforward 10 to 10, right? I think your exposure obviously goes lower as well. I'm not exactly sure what you're trying to get at. In life insurance if you have 100% increase in mortality, you're saying you don't get 100% . . .

FROM THE FLOOR: You might get a 35 or 40% increase in premium out of that.

MR. SKWIRE: Does this have to do with solving for a loss ratio?

MR. CASTILLO: Yes, it could actually be something to do with solving for the same ROI or something like that. It might have something to do with the profit margin.

MR. SKWIRE: Because if you had done the illustration just using the 50% loss ratio, say, without worrying about the details…

MR. CASTILLO: Yes, it could have been a straightforward loss ratio where you say, you know, the loss ratio requirement is 50%, typical of 45 or 50%, and that's your target and you're going to come pretty close. I apologize, but it's been a while since I did that.

MS. CHERYL THOMAS: On the drive down here I noticed that interest rates on billboards that were below five percent for mortgages, and we talked about changing rates here. I'm wondering: say you were using a seven-percent rate to price these products—how frequently you would be redoing rates filings and getting approvals?

MR. SKWIRE: I think it depends heavily on the specific product that you're talking about. Some of these IDI products are noncancelable. Well, you can't change the premiums on noncancelable ones for inforce business, only for new business going forward. In the pricing of those you try to have some conservatism in all of your

assumptions, including interest, and you think about it as a long-term offering and don't worry too much if it goes down this year in the hopes that it's going to cycle back up, but you're very limited in your price response. Some of the other offerings that we talked about feel a little more like group insurance. You have a little more flexibility in addressing the premium rates, and the filing requirements are going to depend on the exact structure of the form. But you certainly do have the ability to change the premiums if that's needed.

FROM THE FLOOR: I don't know too much of the United States, but, Steve, in your presentation, you mentioned a few times that the group coverages do not cover the bonuses, but in individual business, you didn't mention anything. Are you implying that it could be covered?

MR. MILLER: I think you have to look at some history. You can't look at one year in isolation, but if over a two- or three-year period a certain bonus level is sustained, I think it's fair game to insure a portion of that, yes.

UNIDENTIFIED SPEAKER: I think the point is that highly paid executives, because of the limits on group insurance, sometimes make $5,000 or $10,000 a month, and because so much of their comp is back-end bonus, they don't have a lot of protection against a long-term disability. I think some additional coverage is needed, warranted and still prudent within the risk management discipline.

MR. SKWIRE: I think you raised an interesting point in the differences between group and individual coverages. Typically in group insurance the benefit amount is expressed as a percentage of salary, and there's no reason why you couldn't express it as a percentage of salary plus bonus. I think it's just that group plans, in order to keep things as simple as possible for different classes of employees, have tended to just use salary as the basis. For IDI typically you're getting a lot of information on the particular person you're insuring, so as long as you're asking them about salary, it's not that much harder to ask them what their bonus has been for the last few years. And instead of insuring a percentage of all that, you're issuing them a fixed benefit amount, and you might have a guideline that says the amount we issue is equal to such and such a percentage. So it's a little easier for individual companies to customize the coverage to the particular applicant.

MR. CASTILLO: I'm not an underwriter, but our underwriters tell me that there's a lot of art involved in it. But the bottom line is that they look for stability of those bonus amounts, so they look for at least two or three years, and actually try to see where the industry's at or what the person's situation is before they make an offer.