DISABILITY INSURANCE OVERVIEW

David E Scarlett, FSA

DR. BAKER: This afternoon's session, as you've guessed from the program, is strictly on disability. In our critiques each year we receive word from you saying we need more subjects in disability and more discussion. You asked for it and this is part of it, the whole afternoon. It's not exactly a panel but the subjects and the material will, no doubt, be not intertwined. If not intertwined, they'll be parallel.

Before I introduce Steve Boren as the general moderator, I'd just like to say that the people on the schedule for this afternoon are special to me and Dave Scarlett was with me at Monarch and it's nice to see him again. Marvin Goldstein and I had lunch about six months before he joined Paul Revere and we got our heads together and I tried to tell him what I knew about what a medical director did and he was interested enough to join us.

Joan Herzog is a managed care nurse at CNA and Steve can tell you more about her. Chris Brigham's been a member of our group for a few years. I was secretary when he joined and he has never been able to speak to us, and this afternoon we certainly can use him and his experience in examining physicians and occupational health and documenting disability.

So I will introduce to you Dr. Stephen Boren who will moderate the session this afternoon. Stephen is medical director down at CNA, that brick red building down here where you probably took your tour yesterday. He's most famous for his writings and for his editorials in the New England Journal, particularly "I've had a Hard Day, Hillary," and the replies of some physicians to him and his replies. He's been having a good time writing in the journals. He may allude to that this afternoon. So Steve, introduce the afternoon's program.

DR. BOREN: Hi. Thank you very much. I'm Steve Boren from CNA, those two big ugly red buildings on Wabash. The press refers to us as red square. I'm very happy to be here because disability is a very important topic for us all.

We're very glad to have the speakers that we have here. The first one is David Scarlett who used to be with Monarch Life and he was a senior vice president there. Now he's been with Milman & Robertson and unless you're from another planet or you've only been in the insurance business for about three hours, you ought to know what that large company is. I want to welcome David here. He will give us an overall view on disability insurance.

Figure 1

Premiums and Growth Rate

MR. SCARLETT: It's really a pleasure for me to be with you today, and I want to thank Dr. Baker for inviting me. I'd like to give you an overview of the individual disability industry this afternoon, including some thoughts on where it may be headed.

I will talk about the recent experience that we have observed; I'll discuss some of the problems that have led to that experience, then the solutions to those problems. Finally I will give you my thoughts about the future of our industry, including some comments on future profitability.

Recent experience

First, let's look at some of the financial history of our industry from 1980 through 1993. The data are from an article published in our Disability Newsletter, and written by Duane Kidwell and Mark Seliber. The data are based on the statutory results of the nine largest direct writers of non-can DI. These companies account for more than 65 percent of the long-term non can premium in force in the US.

Figure One shows that inforce premiums have grown at a rapid rate, from $395 million, in 1980 to over $2.3 billion in 1993. The annual growth rates have usually been in the 15 to 17 percent range, but note that the rate of growth slowed to 9.9 percent in 1992, and only 7.0 percent in 1993. I think the main reasons for the slower growth in the last few years are higher prices and much tighter underwriting. In other words, I think that the recent rate of growth may be healthy sustainable growth, whereas the high rate of growth in the 80s may have been too rapid and too high to be profitable.
Figure Two shows both incurred claims and the increase in policy reserves as a percentage of premium. Incurred claims include the change in the claim reserve. It’s no secret that worsening morbidity is the primary problem in our business: you can see that incurred claims have increased from 43.5 percent of premium in 1980 to 79.9 percent in 1993. I predict that this 79.9 percent loss ratio will be the highest experienced by these nine companies. The changes that are being made in underwriting, premiums and product will begin to reduce the ratio; in fact much of the increase in this ratio the last few years has been due in part to claim reserve strengthening, which may not be repeated.

You can also see that the increase in policy reserves, or active life reserves, as a percentage of premium have been declining slightly over the years. To some extent this is due to companies adopting the 85 CIDA table, and the two-year preliminary term method of calculating reserves.

Figure Three shows that expenses and commissions have remained fairly constant over the 14-year period, usually in the 21 to 28 percent range. Commissions have come down a bit in the last three years, undoubtedly due in part to a reduction in new sales. I think most companies price for about a 50 to 55 percent loss ratio, hoping for a profit of five to 10 percent of premium. This leaves only about 40 percent of premium for expenses and commissions. You can see that the industry has been experiencing expenses and premiums together which usually exceed 40 percent, and sometimes 50 percent. Although I’m not exactly comparing apples to apples, I think there is an expense/commission problem in our industry, but it is improving.
Figure Four shows that the investment income allocated to the DI line has been growing as a percentage of premium. Some of this increase is due to higher interest rates in the 80s, but of course interest rates now are much lower than in the 1980s. I think this ratio may also be going up because companies are allocating more surplus to the DI line; and because some companies have segregated assets for DI, and have invested them in longer term, higher yielding securities.

Figure Five shows the US statutory profit (before taxes) as a percentage of premium. You can see that profits were at a very healthy 12.1 percent of premium in 1980, and have declined steadily to a negative 8.5 percent in 1993. Profits have been negative since 1986 for these nine companies.

### Poor claims experience

I'd like to make a few comments about the poor claims experience our industry has been experiencing. With respect to past recessions, most of us believed that it was primarily the blue and gray collar risks which were affected. Thus, those companies which were concentrating on the professional, executive marketplace were somewhat immune to the effects of economic cycles. I think that's past history! As everyone knows, an economic recession began in 1990, and it is debatable as to whether or not it has ended. This recent recession has clearly hurt disability writers. Professionals and executives have been affected by this recession, and it is showing up in the experience of most disability companies.

From the experience I have observed at many of my clients, it appears the effect of the economic situation is seen more in reduced claim termination rates, rather than increased incidence rates. It is not uncommon to see decreases in claim termination rates of 15 to 20 percent over the last three years. One of my clients has experienced claim termination rates that were 50 to 65 percent less than the 85 CIDA claim termination rates in the early months of claim duration. It's hard to prove that part of such a reduction is due to recession, but some of us believe it is.

The trend toward longer duration claims is also a function of more mental and nervous disorder claims (I'm also including drug and alcohol abuse claims when I refer to mental and nervous disorders). Mental and nervous claims last 75 to 100 percent longer than other types of claims, according to a survey we published in our Disability Newsletter (and I'll show you some specific company responses to that survey in a few minutes). Mental and nervous claim payments range from 10 to 30 percent of total disability claim payments, with most companies in the 15 percent to 20 percent area. These mental and nervous claims are growing as a percentage of the total each year, and are a cause for great concern in our industry. Many companies in our survey reported a disproportionately high rate of mental and nervous claims in California, and among female policyholders.

AIDS claims also last 60 to 100 percent longer than other claims, according to the same survey. AIDS claims range from one percent of total cash claim payments to about five percent for some companies. Presumably the difference depends on the markets that companies are in, as well as their testing requirements. Some companies are experiencing an increase in the percentage of AIDS claims, and others are seeing a decrease. We concluded in our survey that AIDS benefits, as a percentage of total DI benefits, have been pretty flat over the last few years.

Let's look at a few of the specific companies which contributed to the 1992 M&R survey on AIDS and mental and nervous claims (Figure Six). Company B data shows that from 1989 through the first half of 1992 AIDS claim payments were a steady one percent of total benefit payments. Mental and nervous claims, on the other hand, were at 27 percent of the total in 1989 and grew slightly to 30 percent in 1992.

This same company also reports that the duration of AIDS claims was at 175 percent of the average duration of all claims in 1989, and grew to almost 200 percent (or double) in 1991 and 1992 (Figure Seven). The duration of mental and nervous claims grew from 159 percent of the average of all claims to 167 percent.

Company C in the survey reported that AIDS claims had increased from two percent to three percent of total claim payments (Figure Eight), but that mental and nervous claims had declined from 17.8 percent to 15.7 percent. Obviously, Company C is not having nearly as big a problem with mental and nervous claims as is Company B. This Company gave us some valuable claim duration data (Figure Nine). You can see that the duration of all claims grew from 16 to 20 months from 1989 to 1992, but the duration of AIDS claims grew from 14 to 32 months. The duration of mental and nervous claims was both long and volatile, reaching a peak of 55 months in 1991.

Company K reported that AIDS claims grew from 2.1 percent to 3.1 percent of total benefit payments, and mental and nervous claims grew from 16.1 percent to 18.9 percent (Figure Ten). This company could only give us average claim duration over the entire period. You can see that AIDS claims were at 15.9 months, mental and nervous claims at 14.4 months, and all claims at 7.9 months.

In addition to recession, mental and nervous disorders, and AIDS claims, let's discuss briefly (because I don't want to sound too negative) some of the other problems in the DI industry which have led to poor profits.

### Other DI problems

Underwriting was very liberal back in the early and mid 80s. There was very little blood and urine testing, no one was really worried about AIDS, and guarantees to issue significant coverage, even to uninsurables, were made with reckless abandon to groups and associations. Again in the 80s, companies were playing leapfrog to be sure that they had some competitive advantage in product provisions. Companies insured all pregnancies, not just complications of pregnancy. As new benefits were introduced in the product provision frenzy, they were just given
free of charge to existing policyholders. As interest rates climbed, actuaries found some logic for lowering rates even as product benefits were becoming more liberal.

The attitude of many claim departments was one of service to the claimant. Checks were out the door first, and questions were asked later, or never at all. Now, if liberal underwriting, liberal products, inadequate pricing, and passive claim administration are the problems, what are the solutions?

SOLUTIONS

Tougher underwriting, tighter products, higher prices and proactive claim administration seem logical to me! Let's look at each of these solutions in a little more depth.

**Tougher underwriting**

Most companies have tightened up underwriting practices over the last five or six years, and that will clearly help the industry return to profitability. Blood testing was adopted a number of years ago to help protect companies from the AIDS risk, but it has provided much more protection than just AIDS. Many companies get liver function tests, and are getting quite a few positive hits, presumably due to alcohol abuse. I'm told that at least one lab can do liver function tests on only a dried blood spot sample, and some companies are using this relatively new procedure. As more and more blood testing is done, urine samples are also taken at the same time. The urine samples allow for further testing, including cocaine and other drug screens, which have proven to be valuable to disability carriers. Some companies have decided to test all applicants, regardless of size of the benefits being applied for, in problem areas like California.

Companies are also getting much more income documentation in the underwriting process, and some are giving discounts for getting this information (really, it's a surtax on those applicants who don't submit the data). One company reported to me that there is a large difference in morbidity between the business that has income documented at issue, and that which has no income documentation. I'm convinced that in the past we have overinsured many people, and income documentation is one way to help reduce such overinsurance.

Because of the problem with more and more mental and nervous disorder claims, companies are rejecting applicants with any history of mental or nervous problems, especially stress problems which are job-related in any way. Also, some companies have reduced their offers of guaranteed insurability to groups and associations, as these guarantees have been a part of the profitability problem in the past.

Companies have also studied their experience carefully, and have moved some problem occupations into lower classifications. Examples may be dentists and chiropractors. A few companies have developed a new super class, called 5A+, or 6A, and have not put physicians in it. Thus, physicians are no longer in the top occ class at some companies.
Tighter products

Perhaps the biggest change in product over the last few years is that most disability writers no longer cover normal pregnancies for the first 90 days. Complications of pregnancy are still covered, of course. This change is already helping the industry move back toward profitability, in my opinion.

Most companies no longer sell elimination periods of less than 30 days, and the prices for elimination periods of less than a 90 days are very high.

In response to the mental and nervous disorder problem, a few companies have introduced limits on mental nervous disorder benefits. Most group LTD insurance in the US has limits on mental and nervous disorder benefits. Group carriers acknowledge that the number of mental and nervous claims has increased, but they don't have the financial exposure that individual carriers do. I think that more and more companies will adopt limitations on mental and nervous disorder benefits.

Companies have seen the wisdom of providing accident and sickness benefits with the same benefit and elimination periods. When there is a financial incentive to be disabled from an accident, it's amazing how many uninvolved accidents take place.

In the past, companies have offered guaranteed increases in post-disability benefits, sometimes as high as eight percent per year, without any limitation on the ultimate size of the increase. Now most COLA benefits are tied to some price index and are either capped or the increases do not compound each year.

Higher prices

Premium rates have been increasing in the last few years, especially at shorter elimination periods where experience has been very poor. I think this is a trend that will continue until profitability is at acceptable levels. The fact that interest rates have been declining (at least relative to interest rates in the 80s) is another reason that premium rates are likely to continue increasing in the future. Federal income taxes have increased, and this is another upward pressure on premiums that companies are now recognizing in their pricing.

Many companies are charging higher rates in California and Florida, and some companies have introduced geographic pricing across the entire nation. I think this trend will continue. Companies which have not gone to geographic pricing are recognizing that they are becoming the low-cost company in areas of high risk, and are becoming the high-cost company in the most profitable geographic areas. I think their only viable alternative will be to follow other companies and introduce geographic pricing themselves.

Having gone to unisex rates in the past, many companies have returned to sex-distinct pricing. They realized that when female business is sold on a unisex basis, the profit expectations on female risks are not only reduced, but are actually negative for many companies. In addition to helping correct the female profit problem, sex-distinct rates may provide some competitive advantage with respect to male risks, which is helping the marketing people accept the idea of sex-distinct rates. I think this will be a continuing trend on individual sales, while most companies will still use unisex rates on employer-sponsored business.

Proactive claim administration

Claims people recognize that early contact with claimants and early investigation can improve the opportunity to manage claims successfully. Closer investigation of claims where there are some questions can also yield good results for companies.

Because of the dramatic increase in mental and nervous disorder claims, companies are adding psychologists and psychiatrists to their staffs, either as outside advisors or as company employees. Also, CPAs and tax experts are being added to the advisory staffs because of residual benefits and complex financial documents.

Many companies are seeking out those claimants who would be receptive to a lump sum settlement of their claims. Some companies insist that the claimant be represented by legal counsel to reduce the chances that they will be accused of taking advantage of a disabled person. Some of these companies also understand that the claim reserve is not necessarily a good measure of the present value of future benefits on each individual claim, and are calculating such present values independently of the reserve system.

Even though our policies often provide for long term "own-occupation" coverage, companies have found that some disability claimants are eager for rehabilitation assistance. Companies that have tried rehabilitation report they are getting up to $20 in present and future benefit savings for every $1 spent on rehabilitation.

Reserves

Because claim termination rates have been decreasing, companies have realized that their claim reserves may need to be strengthened. I think much of that strengthening has taken place over the last three or four years, and this has contributed significantly to the downturn in industry earnings.

Because of the adoption of the valuation actuary concept in the US, some DI valuation actuaries have decided that a gross premium valuation is needed on all disability reserves, to be sure that they can sign off on the adequacy of overall reserves. I don't think it's necessary to match assets and liabilities exactly, but the DI actuary does need to do cash flow projections in order to project portfolio earnings rates to use in the gross premium valuation. I think this greater attention to reserve adequacy will bode well for future of our industry.
Summary

In summary, I think the industry is doing the right things to return to profitability. Rates are increasing, underwriting and products are tightening, claim administration is becoming more proactive, and reserves are being strengthened. I think this will lead to future profitability, and future profitability will attract some new companies into the marketplace. The real long-term question is, once profitability has returned, will the industry shoot itself in the foot again in its efforts to do competitive battle?

(Appause.)

DR. BOREN: Thank you very much. Are there any questions?

AUDIENCE MEMBER: My question is since mental illness is such a big part of this, substance abuse I assume is a big part of disability in that section, is it feasible or legal to have an exclusion clause pertaining to what I consider a disease by choice, which is substance abuse? Do companies do that? Is it legal to have an exclusion, like suicide is to life insurance?

DR. SCARLETT: I'm not a lawyer but I am aware that New York state law specifically allows for different benefits for mental and nervous disorders and more and more companies are taking advantage of that. Other states haven't addressed that issue directly, but it seems clear that limitations on the benefits are legal, at least in many states currently.

Now, whether you can exclude it entirely or not, I'm not sure whether you can do that legally. My guess is that if you can limit the benefits, maybe you can limit it to zero which of course, would be an exclusion. I think one thing that you need to keep in mind or that we in the industry need to keep in mind is that these policies have got to be salable, the customer has got to perceive that they're getting value for the premium that they're buying, and the companies that have been putting limitations on mental and nervous disorder benefits in their policies have also said that if the claimant is institutionalized after the two year limit on the benefit period, they will continue to pay benefits if they're institutionalized.

There are some companies that have even said if the mental and nervous disorder is due to an organic disease -- and I'm out of my depth and I don't know exactly what that means -- but an organic disease like Alzheimer's, that that will be covered. So companies are sort of walking a fine line between limiting benefits in the interest of profitability and still having the contract that they want to sell be salable and competitive in the marketplace.

DR. BOREN: One thing you did say basically is that most companies who have gotten into trouble appear to have gotten into trouble because they ignored the basics. They weren't underwriting properly, they weren't pricing properly and they had lousy contract language. As we all know you can get fantastic market share in anything you want if you pay the price but most of the time it's not worth the price. Any other questions?

AUDIENCE MEMBER: A quick question. In your segmentation analysis of poor claims experience you talked about geography. Is there anything related to demographics, such as age or income with experiences worse than expected?

MR. SCARLETT: Yeah, I think if you look at the disability experience over the last maybe 15 years, I think you'll see that the morbidity curve is flattening out and what's causing it is increased morbidity at the younger ages.

So you've got a little higher curve at the younger ages and then it slopes up much more gently by age. I think you also mentioned income. As I think of the actuarial studies, I'm sure that we have looked at income, but we have looked at amount of benefit which is sort of a surrogate for income, and it is true that as the amount of benefit, the actual dollar of monthly benefit, as that goes up, morbidity tends to deteriorate.

There also have been a couple studies done that try to look at income replacement, the percentage of income at time of disability that is going to be covered by the disability benefits. That's a very clear relationship, that as the percentage of income to be replaced by the disability coverage goes up, the morbidity deteriorates significantly.

DR. BAKER: David, you mentioned that the mental and nervous disorders were an extremely large chunk. I always recall low back problems and orthopedic problems, and the study that we did at Monarch showing that low back problem people had so much more in the way of claims of any kind, rather than those people who had no back problems. Are there any other phenomena that showed up like that in tandem with all these back problem people having an increased number of other claims?

MR. SCARLETT: I guess I haven't seen any studies that have connected lower back problems with a multiplicity of ailments. I do know that back problems continue to be a problem for disability companies. Cardiovascular problems continue to be significant. But I still think it's significant that at several companies, if you just isolate new claims, the number one cause of new claims at several companies has become mental and nervous disorders.

Now, if you look at all the claims that are currently on the books, probably backs and cardiovascular are still in excess of mental and nervous but it's starting to go toward the mental and nervous.

DR. BOREN: We'll have to take any other questions later on because we're running out of time. We have to go to our next speaker. I'm sorry. Thank you very much.

MR. SCARLETT: Thank you all very much for having me.

(Appause.)