CUSTOM DISABILITY SOLUTIONS

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In This Issue

Compliance Notes

By Mark Murphy, Director of Contracts and Compliance

Since Compliance Notes would not be complete without the latest installment in the long running CA Department of Insurance Settlement affair, here is the most recent information we can provide.

As we have described in this newsletter previously, the July 2006 CA DOI settlement required disability carriers to submit revised provisions by September 19, 2006, or risk revocation by CA of prior policy form approvals of language now deemed objectionable by CA. We had speculated in prior articles about the potential logistical nightmare that might ensue for the DOI, faced with a deluge of filings all arriving around the deadline. We had even expressed the perhaps naive hope that a "compliance certification" process might be implemented by the DOI, to expedite approvals and prevent more of the same sort of filing logjams that have plagued the DOI and disability carriers for a number of years now. In that sort of process, company officers sign and

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Physician Groups – Are They Worth the Risk?

By Shawn Dutremble, Director, Client Management and Underwriting

Over the last several years, more and more carriers have been willing to liberalize their Long Term Disability (LTD) plans for physicians. You could always find one carrier who was offering the "high maximum" and "own specialty to age 65" for physicians, but today it appears that more carriers are willing to take this risk.

What's going on? Why are even the most disciplined carriers willing to liberalize their contracts for physicians? Have carriers forgotten the late '80s and early '90s when liberal contracts for physicians resulted in steep declines in profits? Why is this the trend in today's market, and is it the right direction for the industry to take? Let's see if we can shed some light on these questions.

Why the Conservatism?

It was the 3rd or 4th day of my disability underwriting training when I heard my first physician group horror story. It's probably the same story we all have heard:

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STD Manual Rate Basis – Is It Really That Important?

By Tim Meyer, Meyer Disability Consulting, Inc.

Just how important are STD manual rates? Due to the level of incidence rates for STD, case-specific experience can be quite credible. Higher credibility means, in general, when compared to LTD, the STD manual rate has significantly less impact in setting case-specific new business and renewal rates. However, the STD manual rate basis is still extremely important in pricing and managing a block of STD business. The purpose of this article is to discuss some of the many ways the STD manual rate impacts pricing and block management.

Small Case New Business and Renewal Business Rating

This is probably the most obvious area where the STD manual rate comes into play. The new business or renewal rate for small cases will be a credibility blend of manual rate and experience rate. Note that credibility formulas vary considerably from company to company (another topic for another day). Depending upon the credibility formula used by your company, STD manual rates will most likely have at least 50 percent weighting in the credibility formula up to 200 life years of exposure, and for many companies the 50 percent weighting is reached at 300 to 400 life years of exposure. Thus, in general, for cases less than 100 lives the STD

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Physician Groups *(cont. from front page)*

Dr. Owen Specialty, a surgeon age 45, accidentally severs his index finger while working at home. Dr. Specialty has fully recovered from his injury but can no longer perform surgeries. Fortunately for Dr. Specialty, his LTD contract has an Own Specialty to age 65 definition of disability, and provides him with 60% of his predisability income (up to $15,000 per month) tax-free. The doctor quickly realizes he can still enjoy a decent lifestyle and not have to work.

This simple example explains why providing a doctor the own specialty to age 65 definition of disability along with a high maximum goes against the purpose of providing LTD coverage.

In the late '80s and early '90s, many disability carriers took substantial hits to their profits because of their physician block and the liberal definitions of disability. However, liberal plan designs were not the only reason for these losses. Managed Health Care (HMO) was introduced during this time, and it changed what doctors could charge for their services. In many instances, doctors were making less money for the same services they were providing prior to the arrival of HMOs.

For the most part, the industry tightened their disability contracts for physicians and developed stricter pricing strategies. Carriers reacted by limiting maximum benefits and restricting the own specialty definition to two years. Some carriers even restricted the own occupation definition to two years for physicians. As you can imagine, these changes along with the health care industry changes settling down have improved the performance for the physician blocks of business.

Why are we, once again, liberalizing our contracts and pricing strategies?

So if the liberal contracts and pricing strategies were bad for business in the '80s and '90s, why is the industry heading back down this slippery slope? Hasn't the industry realized that the physician block of business is performing well because of the cautious and conservative approach? I believe market pressure, pressures to make sales goals, and improved profitability on physicians are some of the reasons we are seeing the return of more liberal plan designs.

Market Pressure:
The disability market is extremely competitive. All carriers want to grow their disability book of business and some carriers have very lofty sales goals. The market is price competitive, contract competitive, and carriers are willing to offer liberalized contracts as a differentiator. Liberalizing contract provisions for physicians is a perfect example of a carrier's reaction to market pressure.

As disability carriers, we are under this type of pressure every day. Sometimes making changes can be positive but other times the change may not be best for the company and even the industry. Market pressure has changed some of the philosophies on physician groups and it remains to be seen whether this will be positive or negative.

Sales Goals:
We all know sales goals are an important measure for all our companies. How do physician groups play into this? The answer is simple: a small group of physicians can mean a decent amount of premium relative to a group the same size in another industry. In my experience, selling a physician group also means you can improve your overall sold rate to manual/calculated rate relationship. In order to sell a case on a physician group, you need to be competitive in price and with contract provisions. Many times this means offering liberal options that we may not be that comfortable offering.

Improved Physician Blocks:
Through the conservative philosophy on physician groups and stable conditions in the health care industry, carriers may have seen improvements on the physician block of business. Improving a block's profitability can sometimes lead to being more aggressive from a pricing strategy and plan provision strategy. Am I certain this has occurred with some carriers on the physician block? No, but combined with other factors, I believe this plays a part in changing philosophy.

Are we going in the right direction?
We need to remain disciplined on the physician block of business. One of the elementary tools we as underwriters use is past experience to predict the future. Are we forgetting the past, or are we convinced that carriers will not experience the losses of the late '80s and '90s? We may not have control over what might negatively impact our business, but we need to be disciplined on the things we can control.

STD Manual Rate Basis *(cont. from front page)*

manual is still the key pricing tool.

Large Case Benefit Changes

Manual rates are often used to determine the relative pricing difference between benefit options. The relative price difference is then applied to actual experience (subject to underwriting judgment and discretion) to determine a proposed rate applicable for the revised plan of benefits. For example:

> **...the STD manual rate basis is still extremely important**

- A current inforce policyholder has a STD benefit plan with a 26-week benefit duration, and has asked for a rate for a plan with a 13-week benefit duration.
- The STD manual rates show that the 13-week plan is 75 percent of the 26-week plan.
- The underwriter might adjust the actual experience under the 26-week plan downward by 25 percent in developing the proposed rates for the 13-week plan.

At the annual SOA meeting in Chicago this fall, Bill Bossi of Disability Insurance Specialists LLC presented the following, which indicates how sensitive STD profitability is to claim duration:

- If pricing anticipates a 65% loss ratio and a 5% profit, and average claim duration is 50 days, then a 1 day increase in duration adds 2% to claim costs (equal to 1.3% of premium).
- Additional claim cost of 1.3% of premium drops after-tax margin to 4.15% or 83% of expected.
- **A 1-day difference in expected claim duration is worth 17% on the bottom line!**

This illustrates the significant impact the STD manual rate can have even for larger cases.

Block Demographic Changes/Shifts

Is the average duration of claim changing? Are incidence rates changing? Are maternity claims changing as a percentage of total claim costs?

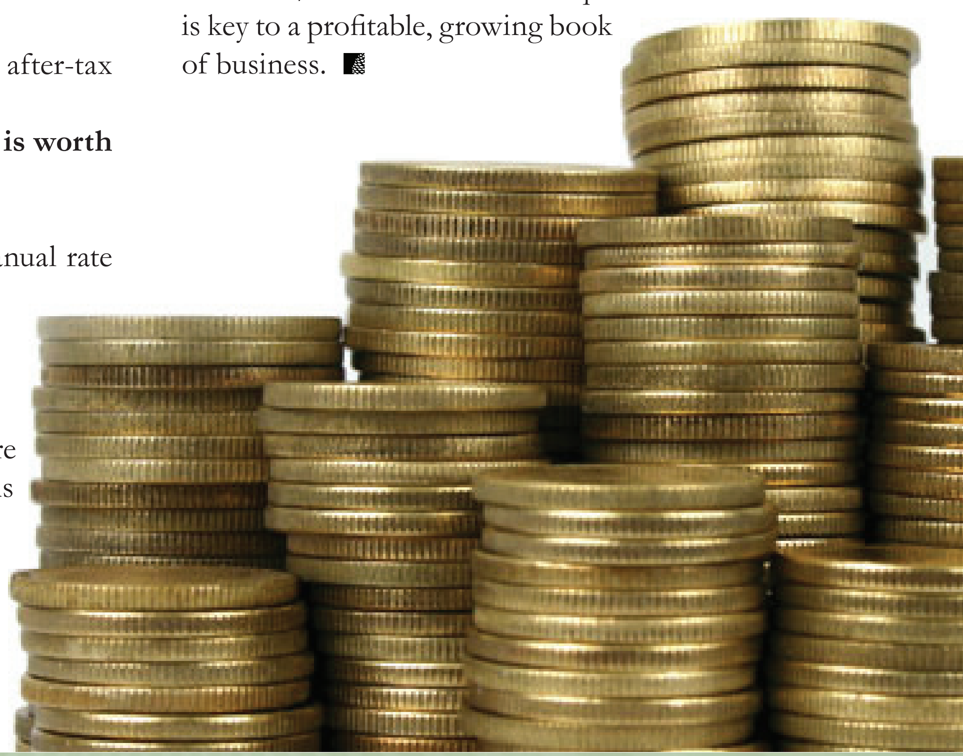
Note that the answer the above questions should also include an analysis of what was "expected". In other words, is the average duration of a claim changing, and is this expected? Are maternity claims changing as a percentage of total claim costs, and is this expected? Are incidence rates changing and is this expected?

There are many reasons why the answer to the above changes could be yes, and yet all are "expected". A shift in mix of business by plan design, SIC, etc., could result in these changes. As could a shift in demographics – higher/lower female content, changes in average age/age distribution of the block, etc. The best measure of "expected" is the manual rate basis. And if the manual rate basis has an adequate rate slope by age, adequate rates by gender, adequate rates by benefit duration, etc., then all of the above changes could be occurring and yet the actual-to-manual claims ratio would remain constant, i.e. the changes are occurring but the resulting change in claim costs was expected.

Case Specific Demographic Shifts

The manual rate can play an important role in the renewal process by identifying changes in case specific demographics. Given no changes in the plan of benefits, a change in manual claim costs of a group over time indicates a change in underlying case demographics. When predicting claims for a future experience period, it may be appropriate to make a demographic adjustment to the historical claims experience to reflect this gradual change. The manual rate basis can serve as the tool for determining the appropriate adjustment to use.

The above are but a few examples of how the STD manual rate basis impacts the pricing and management of a STD block of business. These examples illustrate that devoting resources/time to ensure an adequate STD manual rate basis is key to a profitable, growing book of business.



Compliance Notes *(cont. from front page)*

certify that the provisions are in compliance with the state's applicable laws, rules and regulations (and in this case, the terms of the DOI Settlement); and the states in turn rely on that certification in reviewing the forms.

Well, as expected, the disability industry rose to the challenge. Somewhere in the neighborhood of 45-50 carriers submitted forms. Some companies submitted one or two filings, while others submitted multiple filings. Some companies submitted entire new policy forms, and others submitted amendments or "modular" text to be inserted in previously approved provisions. In the latter instance, the DOI's "logistical nightmare" was compounded by the fact that an adequate review of an amendment or insertion filing really requires that the initial approved policy form or text be on hand as well, in order to evaluate the amendments or insertions in their proper context. Never mind even the challenge for the DOI in trying to ensure some consistency from one reviewer to the next in assessing policy forms of competing carriers, so as to provide a "level playing field" for all disability carriers in the CA market.

We were not surprised to learn, then, that there has not been much DOI response to carriers on the filings. While the DOI has issued some "technical" replies (i.e. use of wrong filing transmittal form or format), we are not aware of any carriers that have received a response from CA regarding the revised provisions themselves.

Faced with mounting inquiries and frustration from carriers and the trades, the DOI has apparently been meeting at length recently to try to establish consistent standards for applying the settlement agreement's provisions to the filings.

The DOI recognizes that there has been a problem in getting prompt responses out to the submissions, and is presently trying to better allocate resources and revise their procedures to try to quickly scan all filings upon receipt, so they might then be able to more quickly identify and advise companies of "deficient" filings. Those companies can then address those deficiencies and re-submit, without having to go to the "bottom of the pile" again.

So where does this leave us now?

Well, for starters, a little bit impatient and not quite as optimistic as before. Yes, I still eagerly scan the day's incoming mail for that elusive CA postmark. And I remain hopeful that our revised provisions, taken almost verbatim from the settlement wording, will pass muster with the reviewers, and will not be accompanied by new objections to previously acceptable wording. Otherwise, we are left to continue waiting and wondering.

Anyway, I gotta run now. I see the mail guy coming.

Editor's note: As we were going to press with this edition of the newsletter, Mark called to say that he had, in fact, just received a reply from CA. But when he called the examiner to discuss a couple points raised in the reply, the examiner advised him to disregard the reply, as it reflected feedback which the DOI now realized was not in accordance with the settlement! Mark continues to eagerly await each day's mail…

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