



**Impact of Disability Insurance Policy Mandates  
Proposed by the California Department of Insurance**

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## Section I. Introduction

Milliman, Inc. has been engaged by America's Health Insurance Plans ("AHIP") on behalf of member companies who are licensed to sell disability income ("DI") insurance in California to prepare a report discussing the actuarial impact of the DI policy language changes that the California Department of Insurance ("the Department") has proposed. The policy language changes are discussed both qualitatively and quantitatively. This report does not assess the legal authority of the Department to impose such changes.

The authors are consulting actuaries employed by Milliman, Inc., who have extensive experience working with insurers and employers regarding disability insurance plans. In preparing this report, we were guided by the Actuarial Standards of Practice (ASOP's) that are promulgated by the Actuarial Standards Board of the American Academy of Actuaries. Specifically, we were guided by ASOP No. 5, "Incurred Health Claim Liabilities", ASOP No. 17, "Expert Testimony by Actuaries," and ASOP No. 41, "Actuarial Communications."

The cost estimates in this report are based on actuarial assumptions derived from historical data, premium rates currently charged by DI insurers in the competitive marketplace, and anticipated future experience. For items which could not be directly derived from historical data or current premium rates, we used actuarial judgment and professional experience to develop the estimates. As with any actuarial estimates, it is likely that future experience will vary from these assumptions. To the extent that such variation occurs, the actual cost impact may vary from our estimates.

To support our analysis, we surveyed a number of AHIP member companies who write group or individual DI insurance, regarding their DI product provisions, their claims experience and litigation costs, as well as consulted with a number of actuarial experts from these companies. Those survey data were aggregated and de-identified when summarized to encourage full responses and assure compliance with antitrust guidelines. The authors did not audit or independently verify the survey responses, except that they did review the responses for reasonableness and consistency. To the extent that any of the data or other information supplied was incorrect or inaccurate, the results of our analysis could be affected.

AHIP has Milliman's permission to submit this report to the Department. In doing so, we expect that the report will become a public document. Milliman does not intend to benefit any third party recipient of its work product. If distributed, we request that this report be distributed in its entirety.

## **Section II. Executive Summary**

In its October 3, 2005, notice to insurers, the Department has proposed a number of significant changes to which DI insurance policies must conform in the state of California. (A copy of the October 3 notice is provided in Attachment A.) These changes would not only affect new product filings but also apply retroactively to policies that the Department has previously approved. The purchasers of group and individual DI insurance, both employers and individuals, will be the ones most affected by the Department's proposed policy language changes for DI policies.

Specifically, the proposed changes will:

- Significantly increase the cost of group and individual DI insurance;
- Limit the range of DI insurance products available to California consumers;
- Reduce the total amount of DI protection per life that Californians may access; and
- Discourage some DI claimants from returning to work.

More than most insurance products, the ultimate cost of DI insurance is affected by the personal motivation of insureds. Most insureds who become disabled want to return to a productive life as soon as medically possible, and DI insurance allows them to restore a portion of their lost income while they are recovering. However, past experience demonstrates that many personal or non-medical (e.g., economic) factors can adversely influence some claimants' motivation to return to work, even after they are medically able. As a result, the cost of DI insurance increases for all consumers.

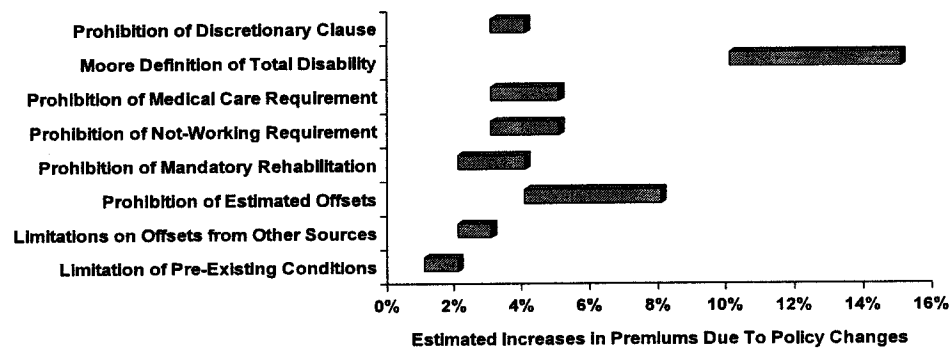
DI insurers have introduced a number of contractual provisions to encourage consumers to return to productive work so as to provide valuable coverage at the lowest possible cost. The policy language changes proposed by the Department weaken many of these provisions. For example, under the Department's proposal:

- Consumers of DI insurance, whether group or individual, will only be able to purchase a more expensive form of DI coverage known as "Pure Own Occupation" or the least expensive form known as "Any Occupation." Consumers will be unable to purchase other currently available options that fall between these two extremes and may better serve their needs.

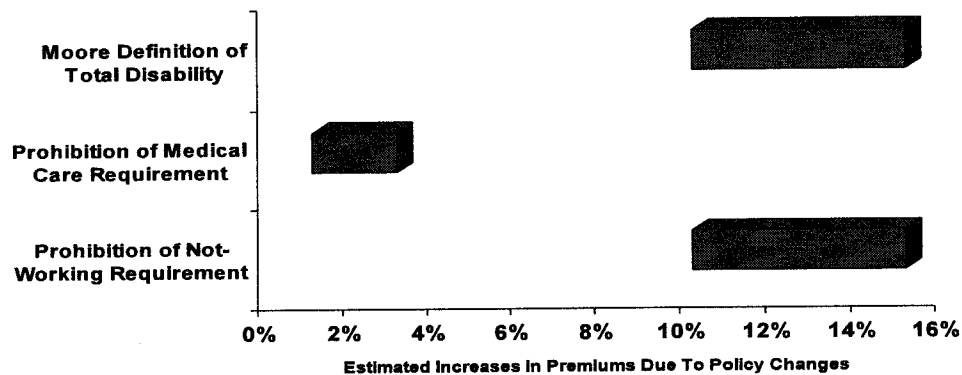
- The requirement that claimants receive regular and appropriate medical care will be prohibited. This requirement was designed to reduce the average duration of claims, the cost of administering those claims, and the resulting cost of insurance.
- Group DI benefits will no longer be reduced by estimated Social Security disability benefits. This prohibition reduces claimants' incentive to apply for Social Security benefits, which both the employer and employee have funded through their payroll taxes, and consequently further increases the cost of insurance.

We estimate that the Department's proposed policy language changes could increase the cost of insurance from 28% to 46% for group DI and 21% to 33% for individual DI, on policies that currently contain all of the prohibited provisions. The anticipated premium increases would be lower for DI policies that currently contain some but not all of the prohibited language. The following charts show the anticipated premium increases, separately for group DI and individual DI, for the specific proposed policy language changes contributing to the increases.

## Impact of DI Policy Changes on Cost of Group DI Insurance



## Impact of DI Policy Changes on Cost of Individual DI Insurance



These anticipated premium increases will be in addition to the significantly higher-than-average premiums currently paid by most California DI consumers. California consumers typically pay 20-70% more for individual DI and 10-15% more for group DI than do consumers in other states. These higher premiums are warranted by historically higher disability claims in California as evidenced by a recent industry study by the Society of Actuaries<sup>1</sup>.

In addition to causing substantially higher costs for DI insurance, the Department's proposed policy changes will limit the DI insurance product choices available to California consumers. For example, the Department would prohibit the following types of DI benefits and policies, which are commonly available to consumers in other states:

- Loss of Income contracts, which reduce disability benefits for earned income during disabilities but which do not distinguish between Total and Residual or Partial disabilities;
- Additional benefits for insureds who are so severely disabled that they cannot perform certain activities of daily living;

<sup>1</sup> "Report of the Individual Disability Income Experience Committee – Analysis of Experience from 1990 to 1999," (IDEC Report), Society of Actuaries, January 2005, pp. 79-84.

- Additional benefits to claimants' 401(k) or pension plans while they are disabled;
- Individual DI buy-out policies, which facilitate the transfer of business ownership between partners resulting from the permanent disablement of one of the partners;
- Individual Key Person policies, which are designed to compensate businesses for the loss of key employees due to disabilities; and
- Survivor Income provisions, which typically pay three months of benefits to the spouse, children or estate of an insured following the death of the insured while disabled.

Should these proposals go into effect, DI insurers, in addition to raising premiums and restricting product options, will be likely to implement more restrictive underwriting rules and reduce the total amount of DI insurance per life that California consumers can purchase, since many of the proposed policy language changes serve to reduce claimants' motivation to return to work. Thus, insureds who are personally motivated to return to work, regardless of the policy provisions, may have lower portions of their incomes covered while disabled.

Although DI insurance provides valuable protection against loss of income due to a disability, relatively few people have this coverage. The U.S. Department of Labor reports in the 2005 National Compensation Survey that only 39% of workers are covered by short-term disability and 29% of workers are covered by long-term disability<sup>2</sup>. The portion of consumers who purchase individual DI insurance is lower. Employers today are facing the increasing cost of healthcare and are, in turn, sharing a greater portion of the cost burden with their employees. When group DI premiums increase, fewer employers may be willing to pay for this coverage. In these cases, some portion of employers will drop the coverage altogether or expect their employees to purchase it. Employees are likewise paying for the higher cost of health care, as well as incurring other financial demands on their disposable income, and consequently, they will be less willing or able to purchase DI coverage on their own.

The likely impact of the Department's imposed policy changes on the California DI consumer is significantly higher premiums, fewer product options, and more restrictive underwriting. The Department's proposal will likely result in fewer insured California residents, and, therefore, decreased financial security.

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<sup>2</sup> "National Compensation Survey: Employee Benefits in Private Industry in the United States," U.S. Department of Labor, U.S. Bureau of Labor Statistics, August 2005, p. 9.

### Section III. The Nature of the Disability Risk

If a person is unable to perform his or her occupation due to an accident or sickness, then that person will most likely suffer an income loss. The purpose of disability insurance is to restore a portion of that lost income while the person remains disabled.

This simple product concept is complicated by a number of factors:

- Difficulties in establishing the existence and extent of the medical condition and the causative relationship between the condition and the disability.
- The potential for adverse selection arising from "asymmetric information", where applicants or employees have material information concerning their personal circumstances that is not available to the insurer.
- The impact of personal motivation on an insured's ability or willingness to perform his or her occupation.
- The risk of overinsurance by which a claimant may receive more income while disabled than before.

Industry studies have shown that the level of benefits relative to pre-disability earnings, the richness of contractual provisions and economic factors can influence both the frequency that insureds become claimants and the duration of the resulting claims.

1. The Transactions of the Society of Actuaries Reports for 1982-84 show that group DI claim costs per dollar of benefit increase as the percentage of income insured increases<sup>3</sup>.
2. The 2005 IDEC Report of the Society of Actuaries provides evidence of how certain contractual provisions and subjective factors affect both claim incidence and claim recovery<sup>4</sup>.

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<sup>3</sup> Transactions of the Society of Actuaries, Reports 1982 and 1984, p. 286 (1982), p. 254 (1984).

<sup>4</sup> IDEC Report, pp. 59-70.

The challenge for group and individual DI insurers is three-fold:

1. Offer DI insurance products that provide valuable protection against income loss due to disability.

DI insurers must provide products that meet the critical needs of the insureds and administer their contractual obligations fairly.

2. Make the products available and affordable to as many people as possible.

DI insurance, sold either on an individual or group basis, is a crucial part of the financial security for working Americans. By including appropriate risk management provisions within their policies, insurers who provide these coverages are able to offer protection to a larger number of customers at more affordable rates.

3. Maintain the financial soundness of the insurance plan.

In order for DI insurance to remain a viable product, it must be profitable for the insurers who provide it. If the product cannot be written profitably, then most insurers will refuse to offer it, and those who remain in the market may face threats to their financial soundness and claim-paying ability.

The remainder of this report reviews in detail the changes to DI policy language that the Department is proposing. Specifically, the report discusses how the proposed changes will reduce the protection that DI products will be able to provide in California, and will substantially increase the cost of DI coverage.

## Section IV. The Department's Proposed DI Policy Language Changes

This section covers each of the categories of policy language changes which the Department outlined in its October 3 notice to insurers.

### 1. Discretionary Clauses

The Department proposes prohibiting the use of the discretionary clause in DI contracts.

The discretionary clause, which is included in DI plans subject to the Employee Retirement Income Security Act (ERISA), vests in the insurer, in its role as plan fiduciary, the responsibility to review all the evidence and documentation submitted by the beneficiary seeking coverage from the plan. The fiduciary is **required by law** to use a level of discretion in interpreting the plan documents, a role formalized in the plan documents through the discretionary clause. This role was reiterated in two Supreme Court decisions, *Firestone v. Bruch* (1989) and *Aetna Health Inc. v. Davila* (2004). Discretionary clauses do not allow the insurer "unfettered" discretion, but are consistent with federal law by which the interpretation of the plan's terms must be grounded on a "reasonable basis," and cannot be arbitrary, capricious or an abuse of discretion.

The presence or absence of the discretionary clause does not affect contractual entitlement for benefits or calculation of benefits. However, without the discretionary clause, the standard of review if a claim is contested will change. Under a discretionary clause, the administrator's claim decision can be overruled only if it is found to be "arbitrary and capricious." Without the discretionary clause, the standard of review is the same "de novo" standard applicable to individual DI plans where a jury can determine whether an insured qualifies for disability benefits.

We estimate that the removal of the discretionary clause would increase group DI premiums between 3% and 4%, based on the following three factors:

#### a. Higher incidence of litigation

Based upon results from the survey of AHIP member DI carriers, the ratio of litigated claims relative to all active claims was 0.6% for group DI carriers and 0.9% for individual DI carriers. Although a number of factors could contribute to the different ratios, we believe the absence of a discretionary clause in individual DI policies is a significant consideration.