

DISABILITY WORKSHOP – 29 OCTOBER 2004

LUMP SUM DISABILITY – A QUESTIONABLE PRODUCT

- Don McKay

I have been around for a long time. I have spent my entire career in the life assurance industry. During this time I have seen many changes in life office practice, but what has not changed is the fact that disability continues to give underwriters, claims assessors and, on occasions, Chief Executives very real problems. It also gives the Ombudsman's Office problems. My particular concern, for present purposes, relates to capital disability cover which pays a benefit in a lump sum and my unease stems from the history of the product.

At this workshop this morning we are talking about a class of business that goes back many years. It has its foundations in Friendly Societies, Guilds and similar bodies. These were associations and groups, primarily of artisans, trades people, banded together for mutual protection against disability and sickness. Friendly Societies played an important role in the development of disability business because they provided the statistics on which life office disability premiums were originally based. They and their like commenced providing disability cover as long ago as the eighteenth century but it was in the twentieth century that significant developments took place.

These developments were not without trauma. We must look to the USA where in the early part of the last century disability business had really taken off. The lump sum contract was becoming extremely popular, sales were booming, underwriting standards were relaxed and the definitions of disability and sickness were being liberalised. By the 1920's all the larger life companies in the USA were selling capital disability cover and many did not appreciate the substantial liabilities they were building up. In 1929 a USA insurance committee issued a word of warning – they recommended a

tightening of benefit provisions and the adoption of a somewhat more conservative rating basis. But this advice came too late. The depression had begun and America was in the middle of an economic crisis. People lost their jobs, stress took its toll, nervous breakdowns were a common occurrence and disability claims flooded in. The result – insurance company losses mounted rapidly, eventually reaching catastrophic proportions. Companies restricted new business, tightened policy wordings and increased premium rates. One company increased its premium rates three times in 1930 alone but by 1932 a number of companies had gone to the wall, were bankrupt and the majority of the remainder had withdrawn from the disability market.

The painful experience of the 1930's has remained fresh in the minds of subsequent generations of insurance managers and it took a long time for the American sickness and disability market to recover.

In UK the picture was much the same. Following the 1930's crash all companies bar two stopped writing lump sum disability. It was not until twenty years later that the disability market was resuscitated but it was resuscitated in a very different form. The contract which was offered was disability income and not capital disability.

The picture in South Africa was somewhat different. In the 1920's companies like Sanlam, Old Mutual and Southern Life, the Australian companies with offices in Cape Town, Colonial Mutual and National Mutual of Australasia, were all writing lump sum disability business. They were seemingly unaffected by the 1930 events which impacted on business in the Northern Hemisphere. They happily continued granting disability cover on a basis which had caused the downfall of companies in other parts of the world.

Then the reassurers arrived on the scene. I think it is fair to say that all the European reassurers who operate in this market, most of whom arrived in South Africa in the 1950's and 1960's, viewed lump sum disability with some concern. They were all aware of the history. But in those days volumes were relatively small, reinsurance capacity was not in demand and the amount of lump sum disability business written by the reassurers represented a small proportion of their total portfolios. But the picture changed and in the 1980's and 1990's the volumes were increasing and the results were worsening, the premiums were too thin and claims control was inadequate. Some insurers were undoubtedly writing this business at a loss. I cannot be categorical but I would suspect that all reassurers were losing money. Certainly the Mercantile and General and Swiss Re were. As the reassurers' losses mounted pressure was put on the insurance companies to increase their premiums. This they did, but the results continued to be disturbing.

And then: crisis. Things really turned sour. In the mid 1990's there was a major hiccup which was triggered by external events. In certain classes of occupation the change in the political scene resulted in restructuring and rethinking in the work place. A number of people were unhappy in their jobs, they were unhappy with their perception of the future of their jobs. This caused a horrific increase in lump sum disability claims and here I have in mind, in particular, the Municipal schemes and the Police schemes. The Municipal schemes were always of doubtful probability but after 1994 the experience worsened markedly. I would describe many of the claims as suspect and the amounts involved were far from insubstantial. Although it was not a repeat of the 1930's events with companies going bankrupt the losses were enormous. As you would expect in the case of Police schemes post traumatic stress disorder was the most significant feature.

Thus the new South Africa brought with it an upsurge in disability claims which was quite unforeseen. I forecast that one day there will be another event, an event not anticipated, outside

the control of the life industry, which will have the same catastrophic effect.

As you will have gathered, and let me stress this is a personal view, I am somewhat negative about lump sum disability business. I am still of the opinion that there are too many problems, too many question marks, too many unknowns, and I do feel that disability income, where claims can be monitored at regular intervals, is a far better product to market.

By now you know I am a prophet of gloom and I am going to continue in this role by raising yet another problem which supports my pessimistic view. This falls under the heading of potential fraud.

See slide – copy attached.

SLIDE 1

Dr Pieter Coetzer, comments in the excellent booklet published by the Swiss Re and the LOA as follows: “The potential lucrative financial reward of capital disability benefits is often the cause of misrepresentation or fraud”. This is very true and in the recent past the Ombudsman’s Office has seen an increase in suspect claims. According to recently published LOA statistics the highest incidence of life assurance fraud occurred in Kwa-Zulu Natal where the number of cases was almost double the combined total of Gauteng and Eastern Cape. Although the LOA figures related to life statistics, it is the Ombudsman Office’s experience that KZN are also the champions, the league leaders, when it comes to disability fraud.

See slide – copy attached.

SLIDE 2

I have examined a number of cases of suspect fraud which this office has seen over the past eighteen months and I have listed a number of characteristics which, whilst not being common to all, feature regularly. As you will see, geographical location KZN heads the list.

Clearly in cases of suspect fraud the Ombudsman's Office has to tread warily. It is not its function to assist people to defraud insurers. On the other hand we cannot be expected to support unsubstantiated accusations against policyholders. However, it is fundamental that complainants who come to us do so with clean hands. We are wholly unwilling to help where there is sufficient evidence of fraud.

So what do we say in these cases? In many cases, we simply say that the disability criteria has not been met. We inform the policyholder that on the evidence available he has not discharged the onus of establishing that his demonstrated disability is of such a nature that it complies with the definition in the insurance contract. Alternatively, we might say, having regard to the disputes of fact, that this is not a case where the Ombudsman's Office should attempt to mediate and adjudicate. We express the view that the issues involved would be more appropriately dealt with by a court of law. There the relevant evidence can be given under oath and subjected to cross-examination.

I have quite deliberately been somewhat negative, but in fact I am proud of the industry in which I have worked for fifty years. You too have every right to be proud. After all, you are the people who are making things happen. As for disability business: I rather fear it will continue to give problems – but when these arise I am confident you will greet and meet them with your customary assurance.