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Why the Future Won't Be Like the Past

A commentary on the SOA's Report on the Lapse and Mortality Experience of Post-Level Premium Period Term Plans (2014)

By Jimmy Atkins

I welcomed the SOA's report on post-level term (PLT) lapse experience with great interest. I have been heavily involved with this form of term life insurance for most of my professional career. I think the committee has done a great job gathering and analyzing the data and demonstrating the biggest predictor of the lapse rate at the end of the initial level premium period is the jump ratio, for example the ratio of the eleventh to the tenth premium on a nominal ten-year term policy. I think their conclusions are a spot-on assessment of the past and the present. However my reading of the marketplace leads me to think that the future for this product will be nothing like the past and we should prepare now for a radically different future.

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My forecast is that the shock lapse rates could very well rise to the highest levels in the report for any and all jump ratios. In a world of rapidly growing social media and technological advancement everyone will know what their options are and someone will make the process easy enough to get even the biggest procrastinator to move. That someone might even be me.

Let me share my history and rationale with you. Term life insurance in the form we sell today has been the predominant form since the early 1980's. The biggest problem for term insurance in those days was deficiency reserves. If the gross premiums were less than the valuation net premiums you had to prefund the difference in a non-tax deductible "deficiency reserve." Special rules disallowing future sufficiencies to offset present deficiencies were in place for Annual Renewable Term (ART). This resulted in straight-forward renewable term insurance being impractical from a capital strain and Return on Equity (ROE) point of view. Not so for long duration life insurance with non-level premiums.

The first attempt to work around these ART deficiency reserve constraints was a whole life policy recast as an ART lookalike product with annually increasing premiums for 20 years before holding level to endowment. The premiums for the first five years were extremely low, but this led to lapse rates of 25-50 percent PER YEAR. At the low end, even 25 percent annual lapse rates could be profitable. At the high end nothing was profitable, especially for reinsurers who were paying allowances at or exceeding 100 percent of premium.

To solve both the deficiency reserve problem and the lapse problem we could just flip the "whole life as ART" concept. Charge a level premium for a limited number of years, then let premiums increase annually. As needed you could push up the premiums after the initial level period to cover anti-selective mortality rates and to produce an overall premium that was not deficient. Under the unitary methodology of the time, even higher Post Level Term (PLT) premiums would bring the reserves during the level period down to economic reserves or lower. These reserving considerations caused the PLT premiums to be higher than was otherwise necessary and so PLT premiums were potentially more profitable than would have otherwise been the case. Of course PLT profitability depends on the margin after claims and the proportion of policies that actually persist and pay those premiums. The fewer people who persist, the lower the potential to earn a profit, and the greater the expected mortality will be as the worst risks are surely persisting, reducing margin on those who persist. Your overall mortality depends on how many "average" lives persist, and an attractive premium is required to retain average lives.

In a typical design of the day after an initial 10 year level premium period the policy continues in force with no evidence of insurability but with the premium increasing 10-fold. Contrast that with the three-fold increase more appropriate for a reentry premium with evidence of insurability. Guaranteed premiums leaped 20-fold at the end of the level period and grew from there.

At the time, there was no statistically credible data on which to base an end-of level-period or "shock" lapse assumption. We did have the experience of the whole life as YRT product. So, making an educated guess and testing sensitivities was the best one could do. I suspect that there were some, but not all, companies and reinsurers that assumed 100 percent lapse at the end of the level period.

By 1990, industry data was developing actual shock lapse results on the five year product and by 1995 on the 10 year product. Actual lapse rates were in the mid-60 percent range but were not uniform. The bigger the dollars involved the higher the lapse rates. Lapse rates were higher on large face cases than small face cases. Older ages lapsed more than younger ages. All these observations are still with us today, as detailed in the SOA report. While

actual lapse rates during the level period were lower than some might have thought the shock lapse rates were a bit higher than anticipated and overall earnings were a little less than expected.

By the late 1990s, change was needed, and raising the premium did not seem to be the right answer. It would just drive more people away. However, if premiums were lowered dramatically for a few years, it might ease people into the higher rates. Ultimately the previous PLT rates would resume keeping the deficiency problem at bay. This would give up some premium per unit but lead to the expectation that even more people would keep their coverage. A range of premium patterns and lapse and mortality combinations were tested to see what pattern would most likely optimize margins and persistency. Making some high level assumptions, which in hindsight are supported by the SOA report, seemed to indicate that a straight-forward five year linear grading of the premiums from the initial level period into the original increasing PLT scale would be close to optimal.

When experience on the 10 year level term product (T10) graded PLT scale began to emerge, lapse rates during the initial level premium period were as low as ever but the shock lapse rate was higher than anticipated and still varied by the demographic measures of age, class, face amount.

Today I am now the president of Legal & General America (LGA), underwriting this same form of term life with Banner Life Insurance Company and The William Penn Life Insurance Company of New York. LGA's current experience is part of the SOA report and is generally consistent with the collective experience in that report. What I have observed is that the shock lapse rates emerging today are higher than the experience of 10 years ago. What is not clear is whether these higher lapses are a result of a more price-sensitive customer base, a lower starting rate or a changing of customer and distributor behavior over time.

Either way I don't think the historical data shown in this report will be a good predictor of customer behavior going forward. In recent months more than one independent brokerage general agent (BGA) has told me their business model is now less about recruiting and serving new brokers and more about soliciting the policy owners of the in force term book for replacement at the end of the level period. When you look at how social networks are developing and financial transactions are becoming digital, it becomes clear that far more policyholders will know they should pay attention to the end of the level period, and many will take action. Mobile technology will make it easier than ever to do so. Activist agents will work this lucrative market and BGAs will handle the orphans. Lapse rates will be higher. The quick claims won't lapse. Even if the owner no longer wants or needs the coverage settlement companies will step in to pay the premiums where it is economically sound. Mortality rates will be higher.

So I believe that the future for these products is likely to involve significantly higher lapses, even for policies with the relatively low jump ratios, as described in the report. By the time policies sold today reach the end of

CONTINUED ON PAGE 38

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their initial level period there will be somebody there, virtually or actually, to assure that policy owners at least attempt to seek a better deal. Even if it is not the agent who initially handled the case, everybody will be solicited to re-enter. Policies will have to make their profits during the level period and 10 year term will be the most affected either with substantial price increases or fading away altogether, like the five year plan did years ago.

Regulation Triple-X has already "cut off the tail" for basic reserves while X-factors have largely eliminated deficiency reserves as a problem. More regulatory changes are in order. It seems like we should have reverted to pure term products, such as a 10 year term policy that expires in 10 years. But two things keep that tail attached. First, without the tail, the nonforfeiture law would require cash values analogous to Triple-X reserves. All 30 year term would become non-viable and 10, 15 and 20 year plans would have to end before age 70. Second, companies still count on PLT profits. Without the tail there are no PLT profits. It's time to take away the tail and simplify the product. Companies should be able to offer simple, affordable term policies and not have to complicate the coverage and the premiums with a tail. But at the same time they should have some relief from the otherwise required cash values. The current product design is driven by law and regulation, and clearly our laws and regulations should change to permit the elimination of the tail.
So, this is a great report. The authors have given us a multi-company study validating the experience I have seen first hand over the last 20 years. But, based on that same experience and my look to the future, lapses will increase. If that occurs, the future will not unfold the same as the past. Pricing actuaries should count on everybody lapsing. The nonforfeiture law must be revised to allow reasonable nonforfeiture values so that we can offer simple, transparent products and consumers will be able to buy the products that best fit their needs. ◻

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