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THE CONTINUING SAGA OF TERM INSURANCE

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While the subject of term insurance has been on the program fairly regularly, it is still one of the hottest topics around.

1. Term life insurance products in the 1980's
   a. Annual renewable term
   b. Reentry term
   c. Deposit term
   d. Modified term - variations on above three products
   e. Decreasing term
   f. Level term
   g. Term insurance plus a side fund

2. Assumptions and experience
   a. Persistency trends
   b. Mortality, including smoker/nonsmoker assumptions and underwriting considerations for reentry products
   c. Expense allocations
   d. Sales compensation
   e. Premium bands and discounts for larger policies
   f. Reserve considerations, including deficiency reserves
   g. Federal income tax considerations
   h. Reinsurance
   i. Conversion rates and costs
   j. Profitability

3. Term insurance sales and markets
   a. Effect of inflation
   b. Effect of consumerism
   c. Distribution methods in the 1980's

MR. RICHARD A SWIFT: It is difficult to predict what is going to happen in the term insurance market during the 1980's. The reason for this is that our environment is going through a continuous state of change. Futurists tell us these changes will continue for a long period of time. Thus, it is impossible to predict all future changes. The key is to be prepared for these changes, and we hope this presentation will help you to be better prepared. I would like to make a few comments regarding recent term insurance trends.

o As you all know, there is a trend to a larger share of the total insurance sales going to term insurance.

o Sales of larger policy sizes have increased. This suggests that competitive pricing on large size policies has had some influence on the buyer. Also, agents are able to write larger policies with lower premiums per 1000 to give the same total premium the insured is willing to pay.

- Companies have raised term commission rates closer to whole life commissions. There may be trends to equalize commission rates in the future.

- And finally, term insurance premiums have been reduced by some companies to the point where one has to wonder what margins are left for profits to the company.

MR. DAVID M. MORDORSKI: Somehow it seems very appropriate to be discussing brokerage term insurance today at Disneyland. I do not know whether it falls into the fantasyland or the adventureland category. I think it is somewhere between those two when you consider things like revertibility, select and ultimate premiums, graded premium life plans, discounts for the second year premium, discounts for multiple premiums, and discounts for annual mode that we have seen in the last few years have made this a very aggressive and fast changing market.

This graphic describes this marketplace.

Age	ART 1975	Graded Premium Life 1981
45	$ 4.18	$1.60
55	$10.12	$3.05

By way of background let me explain that in 1975 Occidental, through its sister company Transamerican Life and Annuity, introduced what was at that time the most competitive annual renewable term plan in the marketplace. Recently, Occidental introduced a product about a month ago, which for about three days, was the most competitive plan in the marketplace. I have shown the per thousand premium rates side by side.

Trendsetter 20 is a graded premium life plan designed to compete in that low cost brokerage market. This is not a fair comparison. It does exaggerate the point. ART100 which is the product that is shown as ART 1975 was an attained age ART product available to any standard risk. Trendsetter 20 is a graded premium life plan and that implies select and ultimate premiums, it's available only to nonsmoker preferred risks and it has a first year going in rate. It is a good illustration of what is needed for a going in premium which is needed in the brokerage low cost protection marketplace. That is what has happened in the last 5 1/2 years.

I am going to talk about assumptions and experience but, I am not going to recite Occidental's experience. I will try to deal in more general terms. By way of background, Occidental has been writing in this competitive term insurance market for many years. The 5 year R&C was then the competitive brokerage term product. In the early 70's it switched over to annual renewable term and now it's revertible graded life. So Occidental's data is extensive.

The first item on the program is persistency trends. I do not expect many arguments if I said the trend in lapse rates has been up. Brokerage term lapse rates have always been high; that dates back to the decreasing term and the annual renewable term plans. There are a significant number of brokers who make a pretty good living by rewriting term insurance every couple of years. They can take their client two years after issue of the original policy and show him how he can get a much lower premium, perhaps a free physical in the process and they get themselves a first year commission also. Almost everybody wins in that deal. Incidentally, if your companies have been in this market and your experience shows the second year lapse rate is coming out higher than the first year lapse rate, you are not alone. It is a common phenomenon of this market that we have been seeing for a number of years. You probably wouldn't be surprised if you found a first year lapse rate around 20% and the second year's rate somewhat higher.

The next item on the agenda is mortality, including smoker and nonsmoker assumptions and underwriting considerations for reentry products. These items could probably qualify as a concurrent session all by themselves. I will make obvious comment that more and more companies are going to nonsmoker discounts and preferred risk discounts. To the extent that more companies do that, it forces everybody else to join in. You do not want to be picking up strictly the smokers or the nonselect risks, so it has a snowballing effect and it is definitely catching on fast.

As far as the underwriting considerations for reentry products, there are a number of pros and cons. A negative consideration is that there is a cost associated with it in terms of the anti-selection introduced. On the other side of the coin, there may be situations, particularly where you are talking about lives who have been underwritten in the past, where it is difficult to justify complete underwriting. You may want to make some underwriting concessions on the basis of cost. Further, if you can guarantee concessions at the original sale, it can be a sales advantage, in that your people can sell the original policy and, at the time of reversion the underwriting concessions can help to keep the business with you. If the client does not have to take that second physical with you and would have to with another company, he will be more interested in staying with you.

Concerning expenses and expense allocations, there is not much doubt about the direction of expenses in terms of allocation. Occidental divides expenses into both fixed and marginal expenses, and looks at profits both before and after overhead. You want to know what your after overhead profits are. You have to cover that overhead and still show a profit, yet it is very helpful to know the marginal impact of the business you are putting on the books.

Concerning sales compensation, a large number of field people do not fully appreciate what is happening to their compensation on the select and ultimate products. What we have seen is a constant first year compensation rate. But, applying compensation rates to the steeply pitched premium scales and the going in first year premium rate, their compensation has been dropping quite rapidly.

One thing that may be seen with the move towards pitched premiums and normal higher first year commission rates is a trend toward level commissions. The industry is not ready for that yet, but it may be the ultimate answer to the problem we are seeing. It is a difficult step right now, at least on the jumbo policies. The industry may have to move to that eventually because of the rewrite activity.

In a number of ways the brokerage market is taking on characteristics typically associated with the big casualty market. The property and casualty rate cycle, or profit cycle, demonstrates how the casualty companies go through this cycle of pulling back and getting into a profit situation, and then continually outbidding each other for the business. The result is a reduction in the premium rates until the industry as a whole is not making any money. Aetna Life & Casualty just announced, on the property and casualty side, that they were pulling back and stepping out of the rate war. We may see this casualty brokerage market cycle ultimately move into the life brokerage business. This is based on the similarity of term life insurance to casualty insurance where, for example, shopping for auto insurance every two years has become common.

In regard to premium bands and discounts for larger policies, there is not much to say, except that virtually everybody is doing it. To a significant extent, those discounts are justified, on both a cost basis and a marketing basis.

The next item on the agenda is one that most companies would prefer not to discuss, reserve considerations including premium deficiency reserves. It is a large and perhaps delicate subject. I will just say that if the deficiency reserve laws were to be applied to the graded premium life plans as if they were strictly ART, and you are not allowed to offset earlier deficiencies with later sufficiency, there are probably a few companies that might be technically insolvent. I am not advocating that type of interpretation. I do not think it is proper - it is almost like a fair trade law or a premium setting law if they are applied that way. Occidental went the indeterminate premium route on graded premium life to eliminate any danger of deficiency reserve requirements, and it might be a wise thing to do. It is nice to know that you do not have the specter of that hanging over you if you use the indeterminate premium approach.

Concerning federal income tax considerations, I am going to duck that for now and merely say that if premium rates in the next five years do the same thing they did in the last five years, perhaps we will not have to worry about federal income taxes because nobody will be making any money.

Reinsurance is the next hot topic on the agenda. Lynn will have good comments on this. It is an extremely competitive market. If there is any life insurance market that is hotter than brokerage term, it is reinsurance. In a way the two are very closely intertwined. It is very fast moving, very aggressive.

Concerning conversion rates and costs, the conversion rates on jumbo policies are significantly less than for the broad mix of term business. When a broker has a client who initially demanded the lowest cost per thousand protection, it is difficult to take that individual and turn him around into a higher outlay for a whole life plan. When you are talking about one, two, or five million dollar policies, it is a steep whole life premium outlay.

Concerning profitability, I certainly cannot give you specific profit results, but you are all actuaries, and I have been talking about assumptions. You can see what has been happening to premium rates in the last several years. Each of you can draw your own conclusions concerning profitability.

In the large metropolitan areas, one of the important things we have seen is the emergence of the very large brokerage shops. Occidental's largest agency wrote one hundred eighty seven million dollars of insurance last month. That is an indication of the emergence of the super large metropolitan brokerage specialist offices. They are definitely a factor in the brokerage market today. At Occidental we see that market as being extremely competitive in all areas, not just price but compensation, services and underwriting. In fact, many brokers in some of these large brokerage shops have assistance with tax and estate planning questions. I may be a big hitter for a large company that does not have very aggressive term products, and encounter a person who wants a two million dollar lowest cost policy, but I will still want some help with my client concerning estate planning. Conventions, brokerage contests and being able to qualify to go to Monte Carlo or Hawaii are very much a part of the brokerage market today.

Another key ingredient in brokerage marketing right now is the brokerage manager. This is the contact between your company and the brokers who are out there. In the market ten years ago, these managers tended to be order takers. Now, they have to be out hustling business. They call up the clients and ask, "Did you place that proposal I gave you last week? Have you seen our new graded premium life plan? How would you like permanent insurance? Do you think you would want to convert some of that business you placed five years ago?" These managers can make a tremendous difference in terms of the contact, the follow up and placing business that is not necessarily the lowest price product in the industry.

Now these items I have been mentioning add up to one other thing, there is a little higher expense of competing in the brokerage market. If you are going to have those kinds of services, you are going to have to pay for the services and pay for good brokerage managers also.

What is a good strategy for a company to follow to compete in this brokerage market? There is just a little common sense that applies to any business, not just life insurance in the brokerage market. That is to identify the segment of the market where you feel your company can be good, perhaps the best, and concentrate on that segment. If you try to be everything to everybody, you are likely to run into problems. This applies to marketing almost anything.

At Occidental we have some unique advantages that perhaps some other companies do not, the fact that we have the size that we do, that we have been in the brokerage market for many years, we have the contacts, we have built up a network of very strong brokerage managers, and we have a product development process that keeps us current all the time. We have a synergistic effect out of all this, which gives us an advantage in that marketplace, enabling us to do some things that other companies cannot. It is nice to be operating from that position rather than from scratch. Making money in the brokerage market in the future is not going to be easy, and there are a large number of risks involved, but it is going to be a growing market. Even if you decide that the brokerage market is not right for your company, and it certainly is not right for everybody, keep your eye on it because there are many innovations coming out of it.

MR. DAVID A. WEBSTER: Beneficial Standard Life entered the deposit term market early in 1978. The company did so with the intent of developing a life insurance product line which would be attractive to successful life insurance salesmen, profitable to the company and valuable to the purchaser. Profit tests were conducted upon deposit type policies with various combinations of ingredients until a satisfactory combination appeared. A ten year and an ART deposit term product were developed.

The ten year plan is a non-par modified premium ordinary life policy with level term rates for the first ten years and an additional first year premium. The additional first year premium is accumulated with the equivalent of 10% interest compounded annually and is available to the insured in the form of cash value at the end of the tenth policy year. Voluntary termination by the insured prior to the tenth policy anniversary results in the forfeiture of the additional first year premium and interest accrued on it. Death of the insured during the first ten years results in the face amount being increased by the additional first year premium and accrued interest. At the end of the tenth policy year, several options are available in lieu of the automatic option which continues coverage on a level face amount and level premium. The options are: (1) "rollover" - which means exchange the policy for a new modified premium whole life at his new attained age, (2) change to a decreasing whole life with level premium (less than level coverage but higher than "rollover"). (3) change to a decreasing term to 100 with level premium and sharper reduction of death benefit (premium less than "rollover"), (4) change to Deposit Annual Renewable Term Plan, or (5) change to any ordinary or modified ordinary policy offered by the company on the date of exchange.

The Deposit Annual Renewable Term policy is a non-par Modified Premium Ten Year Convertible Term Life Insurance policy. Premium rates increase annually. An additional first year premium is collected on this plan and is accumulated with the equivalent of 7.2% interest compounded annually and paid to the policyholder at the end of the tenth year in the form of an endowment. Voluntary termination on the part of the policyholder prior to the end of the tenth year results in forfeiture of the additional first year premium and accrued interest. As in the case of the ten year plan, the death benefit does include the additional first year premium and accrued interest.

Options available to the insured at the end of the tenth policy year include conversion to any Ordinary, Modified Ordinary, or Endowment plan of insurance offered by the company without evidence of insurability. Exchange for a new Deposit Annual Renewable Term at the attained age may be assured by purchasing a Guaranteed Insurability Option Rider with the original policy.

The presence of these policies in our portfolio undoubtedly were a major contributing factor in the large increase of new business experienced by the company during 1979 and 1980.

From my understanding of the evolution of deposit term, the primary objective originally seemed to be to protect both the insurance company and the persisting policyholder against the costs associated with early voluntary termination of the policy. The sensitivity vis-a-vis persistency of the profits to the insurer could be greatly reduced (if not eliminated) by assessing each insured with the initial negative asset share (surplus strain) generated by the issue of his policy. This initial assessment could then be accumulated at interest on his behalf and returned to him when the asset share was at least as large as the initial assessment plus interest. This innovative reasoning paved the way to make the compensation to the selling agent meaningful and encourage this product's sale. After all, if profits were immune to persistency, why not heap all sales compensation into the first year or so? This heaping allows an agent to realize sales dollars sufficient to keep him in the life insurance business.

Although this recital may appear somewhat holistic, it seems to me that a good case can be made for its original development along these lines. If you will allow me, then, to assert this developmental logic onto the deposit term product, I think it comes as quite a pleasant surprise to find another very desirable characteristic in the product. That characteristic is its "inflation durability" as regards the insurance company.

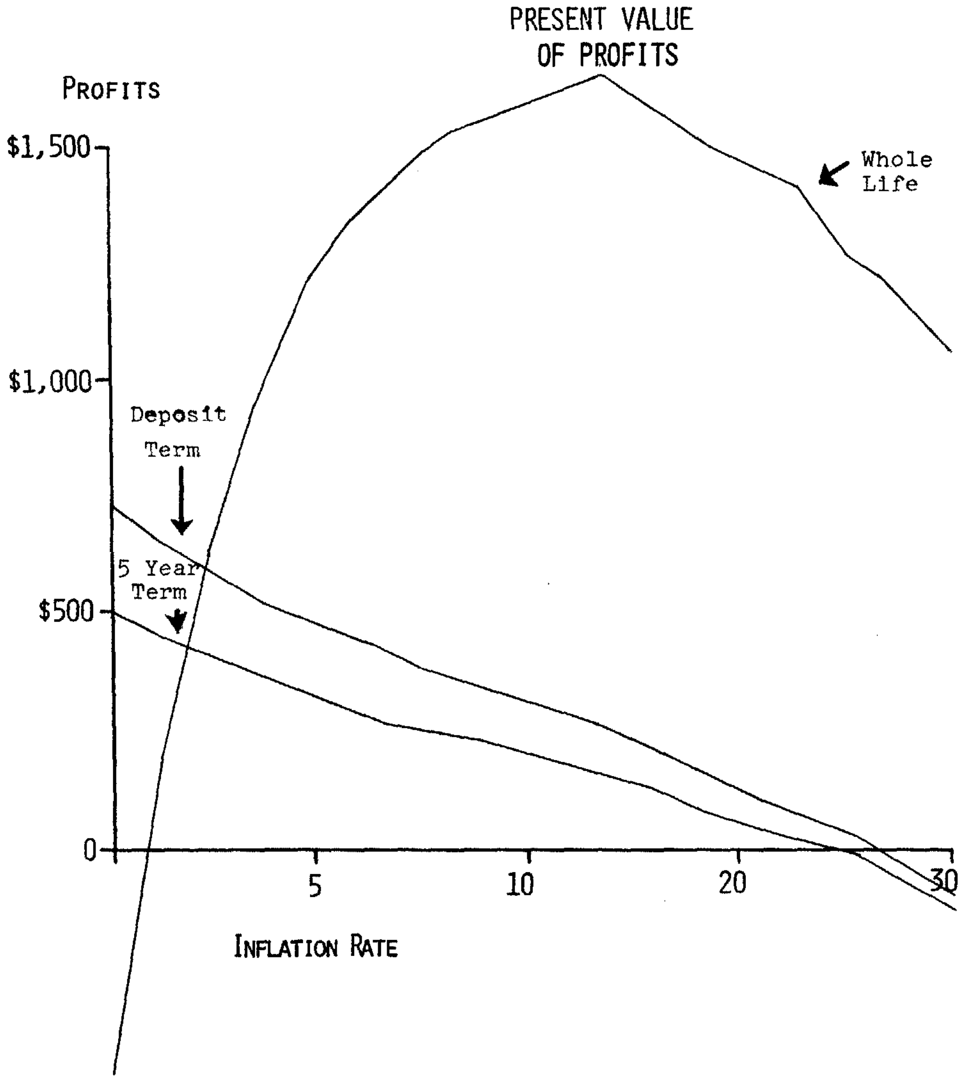
Actuaries have always emphasized the relationship between inflation and investment earnings with the implicit thought that interest earnings over that assumed in pricing tends to offset expense inflation. That is, if the interest earnings in any period of time consist of an underlying assumption for the use of money plus an inflation rate, then the administrative expenses exceeding those anticipated in pricing will be paid for by the portion of investment income in excess of the actuarially assumed interest earnings. Naturally, the extent to which this assumption approaches reality depends upon the relationship between the investable funds generated by the product and the maintenance expenses.

I have selected three products currently being marked in Southern California to test the immunity offered by investment income at different levels of inflation. Figure 1 shows the present value of all future profits generated by the sale of $1,000 annual premium of: (1) a competitive whole life product, (2) our ten year deposit term, and (3) a competitive five year renewable and convertible term policy. The horizontal axis is the inflation rate the vertical axis is the profits generated. Investment income is assumed to be earned at a rate 3% higher than the rate of inflation. Also, profits are discounted at the investment earnings assumption.

All of these assumptions are actuarial judgment with no basis in experience. Our deposit term is such a new arrival that we have not developed any credible experience on it. The other products were selected from competitors so we are truly speculating as to what our experience might likely be if we were to offer such products. However, any set of consistent assumptions would demonstrate similar relative results.

At 3% inflation, the relationship of the different products' profits looks convincingly realistic and in the proper relationship with each other. It takes an inflation rate of more than 10% before excess maintenance expenses offset the impact of excess investment earnings in the whole life product, but each of the other products show continuously decreasing profits as inflation increases. The real lesson seems to be that a competitively priced product of deposit term is able to return a larger present value of profit than other term products and withstand higher rates of inflation somewhat better. For example, at a 3% assumed annual rate of inflation, it returns 47% more present value of profits. As

Figure 1


PRESENT VALUE
OF PROFITS
PROFITS
$1,500
$1,000
$500
0
Deposit
Term
5 Year
Term
Whole
Life
5
10
20
30
INFLATION RATE

inflation climbs to 10%, it returns 59% more ($241 vs. $152). Of course, the standard whole life policy behaves the best by returning 1.8 times the deposit term profit and 2.7 times the five year term at 3% inflation, increasing to 6.7 times and 10.6 times profits respectively at a 10% inflation rate.

This slide (Figure 1) has certainly oversimplified the real world. One major omission is the reaction of the policyholder to the inflation rate. Mathematically stated, inflation is not an independent variable. If I make one adjustment for that and assume that the policyholder takes a maximum loan when the interest rate exceeds 8% (inflation greater than 5%), the picture changes significantly. (Figure 2)

By the time we hit 7% inflation, the whole life product has been wiped out. The investment restriction imposed on the earning power of its assets by the policy loan interest rate cap of 8% (when money is worth 10%), together with increasing maintenance expenses, has turned the product into a loser from the insurance company's view.

This graph is very convincing as to the inflation fighting ability of the deposit term product - there are more investable funds than either pure term or whole life at higher rates of inflation.

Mass marketing programs are flourishing throughout the country in a variety of fields, and our company's success shows that mass merchandising can be applied effectively in the insurance industry as well.

Several types of mass marketing are being used in our industry. Some programs blend the insurance agent into the effort but simply replace one basic function--prospecting--with some form of mass solicitation. Examples of this approach are media ads in which responses are answered by a personal call from the agent.

One of our companies, Fidelity Interstate Life Insurance Company, reaches large numbers of the public by distributing reply cards on mass transit and in other public places.

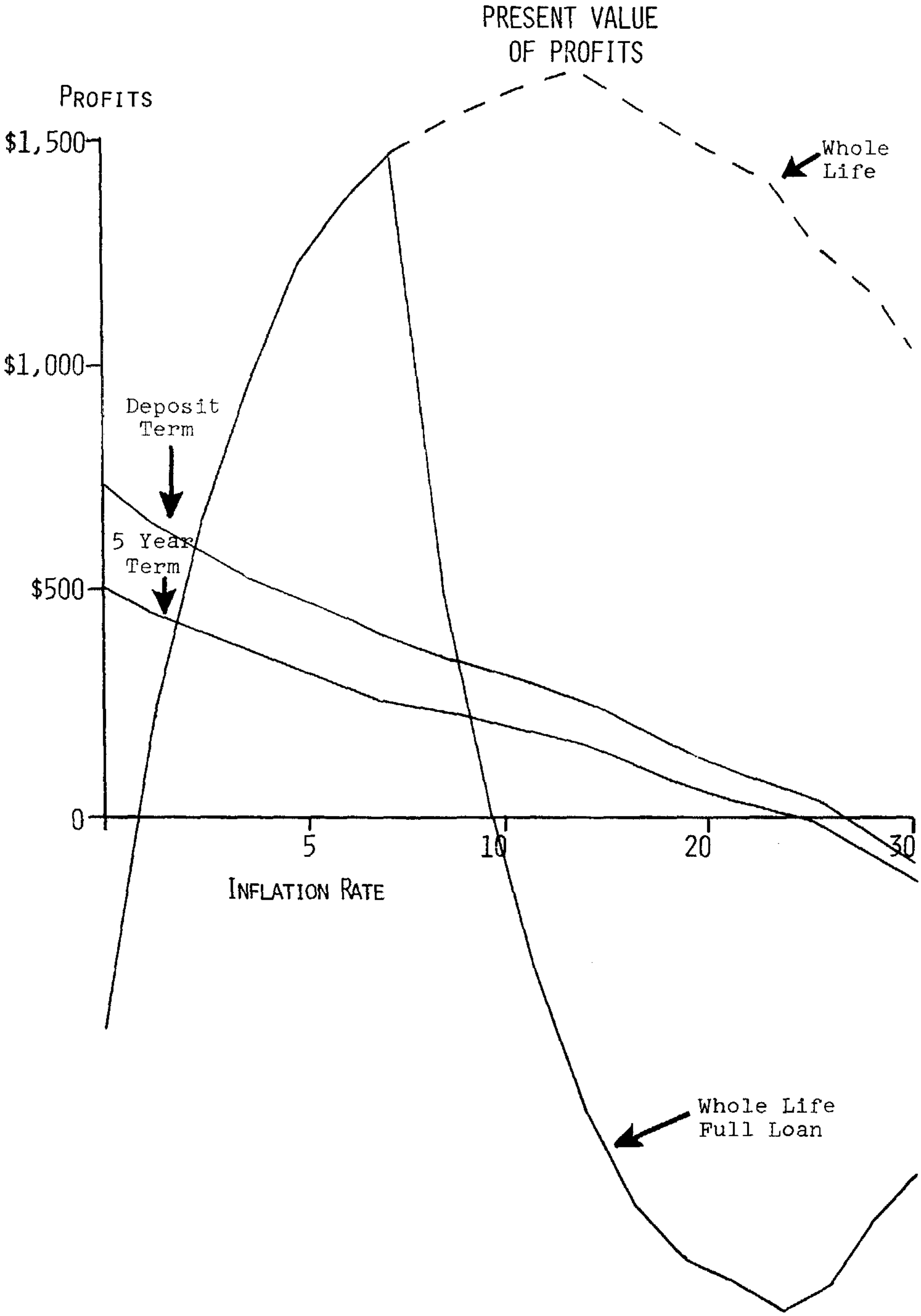
Mass merchandising has successfully used celebrities in newspaper and magazine solicitations. Typically, these are full page ads extolling the product's virtues and explaining the coverage in enough detail to encourage the reader to request the policy.

The method which our company believes offers the greatest potential for success is the mailing list. Lists may be rented for solicitation purposes.

How does an insurance company identify a particular list as potential insurance buyers and then successfully solicit them? What are the pertinent characteristics of successful mass solicitations?

1. Common Characteristics of the Group: Is the group likely to be receptive to an insurance solicitation? For instance, oil company credit cardholders may respond to travel accident insurance plans. Has the group previously responded to a mail solicitation?

Figure 2


PRESENT VALUE
OF PROFITS
PROFITS
$1,500
$1,000
$500
0
5
10
20
30
INFLATION RATE
Whole
Life
Deposit
Term
5 Year
Term
Whole Life
Full Loan

2. Solicitation Capability: Can a solicitation be inserted into a regular mailing or will a special mailing of only this offer be required?

3. Geographical Location of the Group: Is the group spread over several regulatory authorities? Are the characteristics of one geographic pocket of the group likely to be dissimilar from the others?

4. Financial Information: Does this group have the income to respond to your solicitation?

5. Potential Return: What potential premiums may be collected from the group? Is it a $5.00 a week group or a $1,000 per year group?

Much of Beneficial Standard's success has come through a variation of the mailing list--soliciting customers of prestigious third parties whose name has strong buyer appeal. Obviously, this is done in concert with the third party. The parties we deal with are very selective as to what types of solicitations they will allow to be sent to their customers and how often these solicitations may be mailed.

An ideal third-party client will exhibit most of the following characteristics:

1) The client will want to increase revenues by associating with a mass merchandiser of insurance products. If this desire is not obviously present at the onset, it can be cultivated by a good sales presentation. The key stumbling point to overcome many times is the prospective client's reluctance to mass merchandise a product to their proprietary list of customers.

2) Customers on the client's list should have a strong identification with the sponsoring third-party client so that a testimonial from that third party will have a positive influence.

3) The client should have the ability to bill and collect payments from customers on a periodic basis. Credit cardholders are ideal because a regular monthly payment can be included with the other charges. This encourages the steady payment habit necessary for a successful marketing program. In many instances, the billing and collection can be accomplished through physical exchange of computer tapes to further reduce costs.

4) The client should have some logical connection in the list member's mind with the product offered. In addition, the demographics of the list should support the product being marketed. As I mentioned earlier, there is a natural logical link between oil company credit cardholders and a travel accident policy. As another example, holders of so-called "T and E" or "fee-requiring" credit cards, such as American Express, would probably be more receptive to a tax-savings program than would lists of retail discount store customers.

5) The client lists characteristics as to age, spending habits, ability to pay, and geographical area which are quite important and must be judged in concert with the product to be offered. For example, a list of self-employed persons would be a poor match for an offer to buy disability income coverage. It's very important that one of the products that the insurance company plans to market exhibit a positive correlation to the buying habits of the list.

6) The ability of the group to pay when combined with the insurance company's underwriting requirements may be enough to disqualify certain prospective clients. A minimum amount of dollars per collection will be a must for any program and that minimum obviously increases as the cost of the promotion increases or the anticipated return decreases. However, it's important to remember that the higher the premium, the lower the response rate and the higher the persistency.

7) A client with a heavy concentration of customers in a local area will offer some savings to the insurance company in regulatory compliance and better control of test results. Many times, however, this client will not have enough customers to support a mass marketing program.

8) A client with a strong balance sheet is obviously a better risk where such things as billing and collection through their facilities are involved.

In our company, each potential client is measured against a yardstick containing all of the above elements. There are literally thousands of potential clients in the world who score high on that yardstick. Success is first a matter of identifying those clients and then designing an imaginative, innovative marketing program for them.

It's important to remember that in this type of mass marketing program, the client is the third party for whom we prepare the marketing material. Our company conducts the test solicitations, issues the policies, and administers the insurance program. We offer our clients marketing expertise and proven administration capability. Our clients offer the list of prospects and a strong trade name identification. It's a team effort.

Together we develop the desired characteristics of test solicitations to the list of prospects. We conduct our own feasibility studies which tell us the return we must achieve on any particular mailing in order to generate our minimum desirable profits.

Next, we conduct a market test mailing in which 25-75,000 kits are mailed to a selected portion of the list with each individual test containing some different control element (like blue paper vs. orange or slightly different wording in the offer). These tests are then reviewed as to their rate of return, compared with the original feasibility studies, and the winners are selected. The kit which best surpassed the return requirement is usually chosen for the large-volume mailing.

A calendar time is selected for that mailing, and then the entire list (one to five million in size) is prepared for the mailing. Our company's internal administrative units prepare for the expected application influx and the necessary control mechanisms are prepared.

Each mass mailing requires a balance among several items to achieve success. The cost of the promotion, the percentage return, the conversion rate (those who pay the first premium), and the persistency must all combine to produce a product to the insured at a lower cost than our industry's more typical distribution approach. These are elements at war with each other, and only good management of the product line can bring them into balance.

The mass marketed solicitation offers less chance for recovery from mistakes than does the traditional agency approach, since all costs of solicitation are acquired prior to receiving the offsetting premium income. With a regular agency solicitation, at least future commissions will offset poor persistency. And mistakes can represent very large dollars--typical mass market solicitation costs frequently exceed $1,000,000.

MR. J. LYNN PEABODY: In the last few years, term insurance has played a major role in the actuaries' development of new insurance products. The Annual Renewable Term and Deposit Term type products have shared the primary spotlight, while other term products, those which have been traditional in many companies' portfolios, have taken a backseat.

Although I was somewhat disappointed initially at the prospect of being relegated to speaking about "Other Term", it was short lived disappointment when I started to realize just how important these other products really are to many companies' portfolios. Despite the notoriety accorded the other products you've heard discussed, there continues to be a sizeable market for the other term products.

My discussion of Other Term products will deal primarily with these categories:

1. Mortgage and Other Decreasing Term.

2. Level, Other than Annual Renewable Term.

3. Term/Annuity or Term/Fund Combinations.

I'm sure that the Workshops following this Session will provide a good opportunity for you to discuss these products in more detail, so my comments will be more superficial. I'd like to describe some of the recent innovations I've seen in these products, and discuss pricing considerations and industry experience which have formed a basis for their development.

My comments come primarily from the consultant's point of view, which often allows a fleeting glimpse of many different viewpoints and goals relative to these products, but may not meet exactly with your own company. I leave it to each of you to integrate these ideas into your own sphere of operation.

Mortgage Term

Of all the "Other Term" products, probably the one receiving the most attention in recent years has been Mortgage Term. A number of companies have developed new products emphasizing flexibility and responsiveness. The economic environment has created this need, and companies have responded. Sentry Life introduced the HOME Policy (Home Owners Mortgage Expense), which allows coverage to be tailored specifically to the terms of the mortgage such as the amount, duration and amortization schedule. The policyholder can adjust coverage (without proof of insurability) to match a new mortgage if the insured either:

1. obtains a new mortgage,

2. refinances their present home,

3. are subjected to changed interest rates.

The coverage is available on a single or joint life basis.

Sentry isn't the only company to introduce innovative products in this area. Many companies have opted to restrict the flexibility in order to minimize the administrative problems, but the basic concept remains. That is to provide coverage which deals directly with the consumer's needs coupled with the environment's requirements.

Decreasing Term

Standard uniform decreasing term doesn't provide the options for flexibility or responsiveness that are available in Mortgage Term. However, many companies not necessarily heavy in the mortgage market but nonetheless wishing to provide products that are applicable in this area, have developed a more "modernized" Decreasing Term product.

In some cases, they have utilized a decreasing term rider as a supplemental coverage means which is similar to a mortgage policy, but with a wider range of applications than simply mortgage.

Companies have also been able to "modernize" their non-mortgage decreasing term products through banding, premium class differentials and more competitive premiums, but at the same time the profit margins have not been pared as dramatically as with the more competitive term products. This stems primarily from the use of Decreasing Term in a varying market, that is not being used for a sole purpose, which allows more profit through less direct comparison with other companies' products.

An offshoot of standard decreasing term which is enjoying a fair amount of popularity in some markets is single premium uniform decreasing term. This product is being sold through or in conjunction with financial institutions, essentially as a long term, high amount credit insurance. Cash values and commissions follow closely the patterns of standard decreasing term insurance.

Non-Annual Renewable and Convertible Term

This category of "Other Term" includes level term plans (i.e., Term to 65 or 20 Year Term) and "longer than annual" R&C term policies and riders, such as 5 Year R&C. This category has seen less growth than any other categories of term policy, primarily because the attractive ART policies have provided for comparable or better coverage than these products were designed for. Of the companies I've dealt with in revising their term portfolios, this group of products has drawn the least attention.

On the horizon, however, is the possibility of plans such as 5 Year R&C playing a role similar to the current ART. To the extent large amount ART products suffer from poor persistency, a 5 year plan could provide a vehicle for minimizing lapses resulting from increasing premiums each year (due to twisting or to the insured's own desire) and also for spreading commissions over a longer period by flattening the commission scale.

Term/Annuity Combinations

The Term-Fund or Term Annuity concept has been around for several years in numerous forms. I am seeing a trend toward updating and renovating existing combination products by a number of companies, primarily in response to a declining volume of profitable, high reserve permanent insurance which is now flowing through to the term products.

At the risk of oversimplifying, by taking a competitive indeterminate premium ART combined with a no load, current interest, flexible annuity rider (perhaps combined into one policy form to enhance tax advantages or simplicity), manipulate the commission schedule, add a few bells and whistles and you have a basic Universal Life type product, currently touted by some as the savior of the insurance industry in the '80's.

Until companies accept the Universal Life concept as fitting their individual markets or needs, as well as the additional administrative burden that is associated with this flexible product, I think we'll continue to see more combination type products. In the last six months, I've seen companies combine a fund or annuity with a decreasing term to 65, a level term to 70, an ART, and a mortgage term type plan. All these combinations were well thought out, not haphazard combinations, and all appealed to the company's specific marketplace. Although the Universal Life concept will very likely dominate the next decade, I'm not convinced that the Universal product we've seen thus far will do the same. Be looking for more new innovations in the Term-Fund combination product line.

ASSUMPTION, EXPERIENCE AND PRICING CONSIDERATIONS

If I were requested to provide one word summaries of my feelings about recent "Other Term" products (or term products in general) relative to assumptions, experience, and pricing considerations, my response would be optimistic, minimal and scary respectively. I hope that the workshops bring out more concrete or perhaps comforting information in these areas. Actually, these terms may apply more to the ART and Deposit Term products developed recently than those falling in the Other Term category. If this is in fact the case, its probably only because there has been less activity in the Other Term area. I feel certain that the optimistic and perhaps arbitrary assumptions will in fact carry over to the Other Term area as more of these products are introduced.

Here are a few thoughts relative to specific assumptions:

1. Mortality

   Previous Society Reports have shown that industry term mortality is comparable or somewhat higher than permanent plan mortality. This relationship would place term in the 80%-85% of '65-'70 Basic Mortality Table. Whereas this or something slightly higher would once suffice as a pricing assumption, the interaction of nonsmoker mortality, indeterminate premiums and price competitiveness has led to considerably lower assumptions in developing Other Term products, often in the 65%-75% range.

   The Other Term products are expanding into the high amount bands also, which should create some new mortality experience for these particular products. These Other Term products aren't especially suited to the "Jumbo Size Market", but the lower premiums will continue to force the average size higher.

2. Persistency

   As with mortality, the verdict is still to come relative to persistency. In pricing situations, a first year lapse rate around 25% on the mortgage plans may be realistic, moving toward an ultimate 15% in renewal years.

   If renewable term plans such as the 5 Year R&C begin to experience the popularity of the YRT, then persistency may also follow that trend. Hopefully, the longer period of level premiums will improve the persistency by presenting fewer reasonable opportunities to lapse. The larger jump in premiums at the renewal date may have the opposite impact, however.

   The term-fund combination products, if marketed as investment or savings vehicles, should exhibit excellent persistency, even better than standard cash value permanent plans. Much of this will depend on the agent's ability to sell both products as a team, not emphsizing the term or the annuity to the detriment of the other.

   The most recent LIMRA lapse studies (1977-1978) indicate that withdrawals on term insurance (in aggregate) are just slightly higher than permanent plans in the first year, but the gap widens in the next few years to 4%-5% as permanent lapse rates decrease more quickly than term.

   Within the term category, the persistency pattern varies by type of coverage, although not dramatically. I have prepared a slide summarizing the lapse rates, by amount, for four basic categories of term coverage. These comparisons show a basic consistency in the general pattern, with the major differences occurring in the first two or three years. To me, this indicates that early experience is influenced by external forces; (e.g., agent's desires, specific useage of the coverage initially but ending soon after issue) to a greater extent than in later years. Once the block

LIMRA

1977-1978 LONG TERM LAPSE STUDY

LAPSE RATIOS BY AMOUNT

TERM INSURANCE

	LAPSE RATIOS				
POLICY YEAR	5 YEAR R&C	1 YEAR R&C	OTHER LEVEL TERM	DECREASING TERM	ALL TERM
1	20.50%	14.23%	14.48%	16.81%	15.01%
2	15.21	13.58	11.44	13.14	12.96
3	12.03	11.03	9.62	9.97	10.65
4	9.59	9.17	9.06	8.20	9.53
5	7.50	9.66	9.39	8.02	9.21
10	5.48	6.05	8.77	4.66	5.69

of business stabilizes (4 or 5 years), then the term coverages blend together somewhat.

I should also point out that the 5 Year R&C (not shown here) would have an additional 5% lapse in the 6th year, and an additional 3% in the 11th year.

3. Commissions

Commissions on products in the Other Term category continue to climb, in some cases moving toward levels comparable with permanent products. Although these products have not faced the competitive pressures of the ART policy, premiums have been reduced to the level that higher commissions are required to maintain comparable dollars to the agents. In some cases, higher policy fees are being used as a means for boosting commission levels without directly impacting gross premiums. The trend toward higher commissions doesn't have a major impact on the overall profitability of these term products, mainly due to the relatively small magnitude of the costs, even though the percentage change is significant. Perhaps the biggest threat posed by the higher commissions will be in the area of persistency, as the benefit of twisting the business becomes more valuable to the agents.

4. Reinsurance

In many cases, reinsurance has become one of the most, if not the most important element in pricing some of these new term products. In the Other Term category, as with the term plans described earlier, the larger sized policies have made reinsurance even more a necessity. The reinsurers have responded with vigor, providing coinsurance allowance of unparalled magnitude, thereby encouraging the direct writers to charge even lower premiums with relatively little additional risk. I have seen several instances where term policies facing GAAP recoverability problems on a direct writing basis have shown dramatically improved profits when coinsurance is incorporated. Indeed, companies have been facing situations where GAAP profits are improved by reinsuring 100% of the new business written. Reinsurance may become increasingly important in the term-fund combination area as well as with the standard term plans. Direct writers will be able to pass virtually all the mortality risk to the reinsurer, thereby sharing only in the fund related investment risk. In today's economic environment, the possible gains to the direct writer may be substantial relative to the risks assumed.

5. Profitability

Just a brief word about profitability of these Other Term plans. I think marginal profits are being reduced through two means. First, companies are seemingly willing to accept lower profit margins. Lower premiums combined with higher commissions are creating longer breakeven periods. Profits as a % of premium are small, which seemingly goes against the grain of expecting larger returns when risks are greater, as they are with term insurance.

The second means through which profits are being reduced is through smaller margins in the pricing assumptions. The conservative pricing actuary is facing extinction. The margins for adverse deviation in our pricing and GAAP reserve calculations are dwindling in every assumption. The margins for error that we relied upon just a few short years ago are a thing of the past.

TERM INSURANCE SALES & MARKETS
GENERAL AGENCIES AND BRANCH OFFICES

My assignment relative to the topic of term insurance sales and markets was to comment on general agencies and the branch office system of distribution. My first inclination was to comment on how these marketing forms might well hold the key to the stability of the term insurance market in the coming years. Not the key to the most sales in term insurance, but the most stability. My second inclination was to say "No Comment", on the presumption that many companies will be moving away from these marketing arms in the '80's, and toward the brokerage and mass marketed approach. I decided to follow my initial thought, partly because I wouldn't use up my allotted time if I said nothing, but mainly because I do feel strongly about the impact of the agency on this insurance market.

The term insurance market in the '80's is filled with risks. Risks which are spawned by competitive pressures, masked by reinsurance agreements, and accentuated through poor planning on the part of many companies. Some companies probably won't survive the '80's, in part because they left their established niche in the marketplace, small and insignificant as it may have seemed, to follow the "big fish" into the term market. By doing this, they have lost their grasp on one of the more potentially stabilizing forces they have...their relationships with their agents.

In my opinion, in the competitive term insurance market more so than almost any other, the agent controls the business. Term is easier to sell, and hence easier to move. The risks to the insured are less in terms of benefits versus premium, but to the company they're greater. Persistency, which I feel is more agency controlled than any other experience factor, is critical if companies have any hope of recovering higher and higher acquisition costs through lower and lower premiums.

What good are large volumes of term sales, on which you pay high first year commissions or bonuses, if the business gets turned before you even get close to breaking even?

How many of you have been involved recently in pricing term products where perhaps the biggest unknown was not the mortality, interest or expense assumptions, but was actually "What are the brokers going to do with this business next year?" It's a shame that the future of some companies may rest so heavily on so unknown or uncontrollable factor.

The general agency and branch office method of marketing just might provide for closer agency-company relationships than any other mode of distribution. And for term, this relationship is critical!

Here are a few specifics as to why I think the GA and Branch Office marketing approach might be well suited to today's term market:

1. Policy sizes marketed through these means are often somewhat smaller due to the particular market being serviced. This takes the product out of the cut-throat competitive term arena, perhaps allowing greater margins to exist in the premiums.

2. Commissions may be flatter rather than heaped, thereby allowing more room for initial expenses and possibly eliminating the twisting motivation.

3. The agent works more closely with the company, providing a loyalty factor not available through other distribution methods.

4. Agency persistency is often better, allowing the company to follow-up on potential lapses or benefit from a special sales situations.

These points that I've just mentioned are certainly not true in all cases, but for many company situations I think they are. Additionally, these positives are important for permanent business as well as term...but they are especially important for term because of the associated risk and the smaller margins for error.

One of the frequent requirements for survival in the '80's that often surfaces is the need to flatten commission scales as a means to help offset increasing acquisition expenses as well as improve persistency. If in fact these are critical elements to success, then I can see it happening most readily through the GA/Branch Office marketing arm.

It's also possible that the sales of the "Other Term" products I discussed earlier are especially well suited to GA's and Branch Office distribution. If the adage that "insurance is sold not bought" holds true, it's especially applicable to the Other Term type products. I think YRT sells itself, but not so for mortgage or decreasing term or term-fund combinations. The need for insurance must be established, the lack of same highlighted, and the sale consummated using the vehicle that the company has provided to the agent. These Other Term products don't fit every need. The agent and company must be in tune with each other to make the most suitable sale with the most suitable product. The GA and Branch Office system may have the best chance to make this work.

MR. DONALD M. PETERSON: On the graded premium life policy, can you give me some more details on it? Is it a whole life policy or renewal term to 100?

MR. MORDORSKI: It is a whole life policy with graded premiums, that grade up to a level premium. It has cash values. The initial premiums are very low, very competitive in the low cost marketplace. They grade over 10, 20, or 30 years or to a certain attained age where they grade into a level premium and have cash values at that point.

MR. PETERSON: When will the cash values start, after 5 or 10 years?

MR. MORDORSKI: Usually it is later. Ours starts with cash values at age 67 for females and age 75 for males.

MR. LAWRENCE SILKES: Your description of pricing was very interesting. It is not covered in the study notes. When using marginal income, do you set specified levels of production that you have to meet in order for the product to be successful?

MR. MORDORSKI: I participated in a panel in Montreal last October, and we talked about pricing objectives and surplus requirements. We run a model of our business and throw in production estimates with overhead as a fixed expense. You can play with different production assumptions and different levels of overhead as to whether you want to increase overhead for agency expansion, advertising, or different levels of production at different premium rates, and look at the total block of business down the road and the profits that emerge looking at your whole line or whole block.

MR. SILKES: Now what happens when you do not meet your production goals, do you cut back the product?

MR. MORDORSKI: You have problems if you do not meet your production goal. That's not much different than any type of business or any organization. When you do not meet your production goals, your expense factors are no longer appropriate because you do not have enough units to spread them over.

MR. SILKES: In New York there seems to be recurrence of a one year modified whole life product that really resembles term. It is a one year modified whole life plus cash value product. It has a low premium coming in, and if it is minimum deposited, the second premium comes in at a level of a term premium. But commissions on the product are similar to whole life commissions. Have you come into competition with that?

MR. MORDORSKI: I am not familiar with it. I have seen some products in the marketplace which are marketed as minimum deposit or whole life products where it looks like the companies are making all their income off of the policy loan interest rate. Is that what you are talking about?

MR. SILKES: The product design is merely designed to be competitive with term and that outlay is equivalent to that outlay as if you bought your graded premium whole life.

MR. MORDORSKI: We do not have such a product, I have seen a few of those advertised in the trade publications.

MR. STEVEN R. GRAINGER: Has anyone had any success with having second or third year persistency bonuses to solve the lapse problem on a large level?

MR. MORDORSKI: The second or third year persistency bonus could help. Occidental has had persistency bonuses of various sorts in various products from time to time. If you are talking about competitive brokerage product, and the broker is going to replace it for commission, he is going to leave the product with you for two years, get a 50% front end, 5% second year commission and then the third year he is going to rewrite it for 50%. If he is going to do that and he can get his client a lower premium rate, it's hard for me to envision why a 5 or 10% persistency bonus in the third year is going to make that much of a difference.

MR. PEABODY: The type of agency distribution system is very critical to how persistency bonuses will work. It will depend on the loyalty of the agent to the company and whether or not they will accept a bonus in exchange for their hanging on to the business longer. You certainly do not have that in the brokerage area.

MR. SWIFT: I imagine there is no need for that in a deposit term type coverage because you have a built in persistency incentive.

MR. WEBSTER: Theoretically, this is right.

MR. SOLOMON GOLDFINGER: You said you had doubts as to whether universal life will be the product that will sweep the industry over the '80's. Could you comment on what accounts for your doubts?

MR. PEABODY: Where the industry moves very fast in some areas, it is still very conservative and there are many people in the industry, especially in the management of insurance companies that are very slow to respond to new innovations, when the innovations are going to require potentially significant changes in their administrative systems or in moving away from their historical market. I do not think that the universal life concept has been quickly grasped in its current state. Some of the larger companies and now some of the smaller companies are starting to move into it. As soon as some of the tax implications are cleared up you will probably see a move to that market, but small and medium size companies are more prone to doing their own thing, modifying things to fit their own individual company and their own individual market more than taking a general product. The concept of the universal life, the term combined with the fund build up may be the concept with which we are going to be dealing. As far as the specific products that we have seen so far, there are going to be numerous changes to those products with individual companies adding things that are going to fit their needs.

MR. SWIFT: Flexible life is going to be a dominant product, but it may not be exactly the same as what universal life looks like now.

MR. MILTON L. BROWN: Do you improve your GAAP profit by reinsuring 100% of the term policies you write? Where does that come from? Do the reinsurers make a profit on it?

MR. PEABODY: I do not know. If you talk to some of the reinsurers, they maybe doubtful as to whether they are making the profits or not. It is deceptive to some extent, but it comes from the standpoint of the company that's doing the pricing and developing the GAAP assumptions. The reinsurance allowances that they are receiving are based on the reinsurers ideas as to how much allowance they can pay and still make their own profits. But the company that is reinsuring the business, especially a small company that might have a $30,000 or $50,000 retention and yet selling $100,000 or $250,000 minimum size policies are probably GAAPing business on what might be a conservative assumption basis to some of the coinsurers, but it is not necessarily conservative to the small company. What happens is that, based on the GAAP assumptions that these companies are using, when they bring in these coinsurance allowances as additional income to the company, they turn out to be in a more profitable situation than they were in if they had written the business on a direct basis. Obviously, if experience turns out as the reinsurer is expecting, they will make their money and the smaller company, the direct writer, will probably make more than what their assumptions show they will make. The small company is not able to control that, they have to build these margins into their GAAP assumptions to some extent. They cannot worry about what assumptions the reinsurer is using. They have to concern themselves with the assumptions in which they are comfortable. So it is a misnomer to say they will make more profits, obviously they will make whatever profits develop, based on the experience. But looking at it from a GAAP standpoint, based on the assumptions that are underlying it, to the direct writers it looks like they are making more.

MR. BROWN: In line with the statement that the small company uses conservative assumptions, should you use the same assumptions on the direct side as are used on the reinsurance side for GAAP? Should it be aggressive in its assumption for GAAP on reinsurance?

MR. PEABODY: Do you mean having different assumptions built into the coinsurance GAAP factors as opposed to the direct business GAAP factors?

MR. BROWN: Yes.

MR. PEABODY: I am not sure from a standpoint of a benefit reserve. It would be very difficult to do that, because you are anticipating from the company's standpoint that the reinsurer is going to cover exactly the same risks as your company has. It may be possible from the standpoint of acquisition expenses that it would be feasible. In fact, if these companies end up adjusting their acquisition expenses on an actual to expected basis, it may turn out to be true anyway, but from a benefits factor standpoint it would probably not be feasible.