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# TERM INSURANCE

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   b. Interaction with Universal Life and other non-traditional products
   c. Future of term insurance

2. Recent mortality and persistency experience
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MR. J. LYNN PEABODY: Exactly two years ago there were spring meetings in Anaheim and Ottawa, each having a session on "The Continuing Saga of Term Insurance". As I read over our presentations and what was said two years ago I was a little surprised by some of the comments made then. Some of the things to come out of this session are things we feared or thought might have happened a few years ago. Some of the problems we have today are the same, and it does not appear we have made great strides in solving them. I think some problems may have gotten even worse.

In putting together today's panel I thought it would be interesting to get people who may have different perspectives in the term insurance story. I looked for the actuary of a marketing company - the type of company that has been a market leader.

Then I thought I would try to find the actuary of a reinsurance company - the type of company that has been helping the marketing company be able to sell these products at such competitive rates. Finally, I thought I could add the view point of a consultant who has to explain to clients why they can not be or can be a marketing company with or without the help of a reinsurer.

MR. EDWARD B. MARTIN: To kick off today's session, I will be making some remarks relative to that section of the program labeled cost considerations. What I will try to do is identify many of those areas and questions that need to be considered when a company decides some changes are needed in its term portfolio. My list is certainly not exhaustive and not particularly original, but I hope that I can touch on most of the key areas and offer a good jumping off point for today's session.

In addition to offering their thoughts on this general area of the program outline, Lynn will be exploring recent mortality and persistency experience on term business, while Bernie will be kicking off the discussion with respect to trends in product design. I do not think any of these sections are mutually exclusive, nor are they meant to be, but rather we hope that they offer a structure which will facilitate some good discussion, both on the part of the panelists and also from the audience. Since I have either the fortunate or unfortunate opportunity to be first, I will apologize in advance if some of my remarks tend to cross over into the general subject area of my co-panelists.

I doubt that there is anyone in the audience today who is associated with the life insurance business who has not felt the challenge of the term marketplace in recent years. The proliferation of products and the extreme pressure of more and more competitive products has resulted in an ongoing need to keep abreast of the marketplace and to keep our products up to date. Among other things, this pressure will manifest itself in the form of sagging sales, reduced agency productivity and poor persistency on in-force business due to the more competitive products being offered. When first confronted by a key agent with the latest product being offered by a competitor, our first reaction is probably "that's crazy". Either reinsurance terms are supporting the product or the company is hanging its hat on tax benefits such as 818(c), or both. While I am not going to attempt to dispute the role of either factor in today's term marketplace, focusing our attention solely on these two considerations overlooks numerous other factors that a company must take into account in developing its term products.

An aspect of product development that I feel is of prime importance, and this is not unique to the development of a term product, is open, two-way communication with the distribution system. This needs to be ongoing communication. A company has to understand its markets, it has to understand its agents, its brokers. In many ways, a company's agents and brokers are its market. It is impossible to be successful on an ongoing basis without knowing and understanding the needs of your marketplace.

It is also crucial that the product development team have an up-to-date awareness of the competition: What is being sold? What are the pros and cons of various product forms? What levels of rates are being offered in the marketplace? Ideally, what is the competition thinking? What is the competition going to do next month? The shelf life of term products in recent years has been astonishingly short. A company cannot afford to invest the effort required in product development without an ongoing finger on the marketplace.

In developing a term product, what factors does a company need to consider? One of the first questions that a company has to deal with concerns the product design. Much of what is being sold in the term marketplace today is of a select and ultimate form. This would include graded premium whole life, which I include as a term plan, and the various forms of startover or revertible term. These product designs have emerged for a variety of reasons, the most prominent of which is a desire to offer more and more competitive rates. From a primarily attained age ART market in the mid 70's, we have seen, first, smoker/non-smoker splits followed by select and ultimate rate patterns in an effort to produce the lowest going in price possible. Revertible term and graded premium whole life policy designs do offer other

potential advantages. They at least theoretically will appeal to the more health conscious insurance buyer who remains confident of his ability at any time to requalify for a new first year rate. Deficiency reserves can be minimized, particularly with graded premium whole life. Re-entry features at least in concept offer an inducement to good persistency and an opportunity to pay a little more in commissions to the agency.

The obvious potential problems that a company faces with a select and ultimate rate pattern are (1) the short term risk of poor persistency and (2) the longer term risk of significant mortality antiselection. I personallly feel that the term market has entered a transition period. The feared short term persistency problems with select and ultimate products are starting to emerge and this just increases the fear that the longer term mortality worry will also be realized. I do not profess to know what the resulting products will be, whether we will see flatter rate scales, level commissions, high-low premium structure, or some combination. The key is that the product design has to be both marketable and also match the risks being insured or the product will not be viable. Many products being sold today do not meet this latter requirement, and thus change is inevitable.

I would like to touch on the key experience assumptions, starting with mortality. The competitive products being sold today require very aggressive mortality assumptions to be profitable. If your company's underwriting practices have produced exceptionally good mortality experience, this may not be a problem. If not, to profitably sell a new term product, you will need to develop strategies for improving mortality ratios. Some companies that are very active in the competitive term market have adopted significantly more stringent underwriting requirements for their term products than for other products in their portfolio. This can even involve putting more than one underwriting action on the same applicant, depending upon which product ends up being issued. The frequency of business decisions in the underwriting process may need to be curtailed significantly.

I have a general concern about the process of determining mortality assumptions. I will illustrate this with the following example, in which the numbers are meant to be illustrative only, not necessarily actual. Many companies do not have sufficient data of their own to be able to derive mortality assumptions. The starting point is usually the Society of Actuaries' inter-company studies. The most recent study of medically-examined lives showed an aggregate ratio of 68.7% of the 1965-70 Basic tables. Since the ratios have trended downward, and because the most recent study is a few years old, many companies project a continuation of the trend, to, say, 65%. Recent studies of mortality on large-amount policies have shown more favorable experience on the larger amounts. Thus, companies with a high minimum size policy, or perhaps with some high amount bands, will incorporate a further discount to, say, 60%. Then, of course, there is a non-smoker discount. If I make the assumptions that (a) two-thirds of the business is non-smoker, and (b) the ratio of smoker mortality to non-smoker mortality is approximately two to one, then the expected ratio is 45%. Perhaps no company has gone through exactly that argument, but thinking similar to that has certainly taken place. My question is how much double counting has

taken place in this process. I do not think that a 45% mortality ratio is too much different from that actually necessary to produce acceptable results on some of the term products being sold.

This may be a good time to mention smoker/non-smoker products. This is an item that was mentioned as a consideration in the outline, but I strongly feel that unless you have extremely good control over your market, selling aggregate rates today is a serious mistake. I do not think you can avoid antiselection. A related point - our general observation is that smoker rates today are too low relative to non-smoker rates. This could cause frustration if you develop your mortality assumptions and then try to develop competitive smoker rates.

Before leaving the mortality question, probably one of the greatest concerns relates to lapses and the relationship between lapses and mortality. Term lapse rates have been high, at least by historical standards, and probably will continue to be high as long as a policyholder can get a lower rate and a free physical, and the agent can get a first year commission. Whether or not we will be able to achieve our optimistic mortality assumptions in renewal years is a significant question if you believe that many or most of your healthy lives will regularly replace their policies.

In considering term products, you do need to carefully evaluate persistency prospects. If recent experience trends continue, it will be difficult for many, if not most, companies to recoup the front end investment required of today's products. The company that can find ways to either improve persistency on existing products, or that can develop product designs less dependent on it can be very successful.

The area of commissions and expenses is one which I do not think has gotten the attention it deserves with the focus on lapse rates and reinsurance and federal income taxes. Expense considerations can be significant from a number of angles. The shelf life of today's products is extremely short. This requires almost continual product development effort, the cost of which can be a severe handicap to a low volume producer. Likewise, many larger companies capable of producing large volumes and supporting the needed product development are saddled with large and often inefficient organizations, resulting in high fixed costs which need to be covered. Relatively small differentials in expense and commission levels can mean the difference between profit and loss at today's rate levels. I think this is often overlooked as a success factor for many of the companies who have been very successful in this market.

Reinsurance almost inevitably receives credit and/or blame, depending upon your point of view, for the explosion in the term market in recent years. There is good reason for this. The level of competition in the direct marketplace has certainly been present in the reinsurance marketplace, perhaps to an even greater degree. Many smaller and medium size companies have needed the surplus support of reinsurers to write the volumes of business being produced. Reinsurers, in pursuit of market share, have been almost eager to offer not only aggressive terms, but terms with heavy front end surplus support. We are beginning to see some change, however. Lapse rates are making it difficult for reinsurers to recoup the front end investment

made in many deals. Reinsurance mortality has not been as good as expected recently for many reinsurers. The reinsurance marketplace will continue to be competitive and attractive reinsurance rates will continue to be available. But the pressure will be there to lessen the front end strain so that the persistency risk is more evenly shared between the reinsurer and the ceding company.

In addition to reinsurance, 818(c) is the other factor frequently cited as driving the term market. Most of us have probably heard it said on occasion that companies could afford to give the business away to get the $21 or $19 per thousand reserve credit. While this has certainly been a factor, the Senate made it clear in the deliberations surrounding TEFRA that graded premium whole life should not be receiving the permanent 818(c) credit unless substantial early cash values develop. This would exclude most of today's competitive products. What, if any, post Stop Gap 818(c) benefit will be available is another question.

Some companies have developed products which develop early cash values specifically designed to help insure qualification for the permanent 818(c) benefit. This is an option that could be considered, but may be a temporary one, depending on what happens after Stop Gap. In the meantime, companies do continue to issue term products on which they are taking a permanent 818(c) election. This will remain as a factor holding term rates down until the question is settled once and for all. Companies taking this election are counting on the hope that, whatever happens to the 818(c) election, the benefit on in-force business will not be lost.

There are a couple of other items that I wanted to just touch on. One is deficiency reserves. Deficiency reserves used to be a limiting factor in the term market, but, except in certain markets, indeterminate premium products and graded premium products have largely eliminated this as a consideration. A company will want to carefully examine the laws of the jurisdictions that it operates in, however. Certain graded premium designs, in particular, may have deficiency reserve implications. Finally, in the development of any new term product, a company will need to consider what, if anything, to do with in-force term policies. The trade-off between lowering premiums on existing policies versus the risk of higher lapse and mortality antiselection if nothing is done, will have to be evaluated. This is particularly key if prior products do not differentiate between smokers and non-smokers when new products do. A company will want to work closely with its reinsurer in evaluating action with respect to the in-force block.

I realize I have sounded pretty negative on the term market. This is not really my intention. I believe the term market is an important one, one that will not go away in spite of the success of products such as Universal Life. Term insurance fits a very legitimate insurance need and demand will be there. If the demand is there, someone will find a way to write it profitably. I think, however, that will mean some movement away from today's products. As I mentioned earlier, the design of the product has to match the risk. The term insurance market has taken on many of the characteristics of the property/casualty market. If it is perceived as a short term market by agents and buyers, current structures of very low initial premiums

which rise rapidly, plus high front end expenses and commissions just will not be supportable in the long term. There is a significant market out there which could prove very profitable for those companies who are creative, efficient and entrepreneurial enough to take advantage of it.

MR. BURNETT A. HALSTEAD, JR.: Following up on 818(c), it seems to me, from comments I have heard, that the major term insurance pricing factor may have become taxes rather than mortality and persistency.

I am not sure why this is, since it does not seem to me the tax benefit is nearly as big as most people think it is. At least it is not for us. If we had taken all the 818(c) benefits available to us we could have had current tax loss carryovers of about 1/2 billion dollars with little or no prospect of ever using them.

The carryovers would thus expire unused and we would not receive any tax benefit. If we had priced for it we would have lost money. Even if we had not priced for it, we might have lost money anyway by taking 818(c) since tax losses expire and reversals of tax benefits do not.

The point that seems to be missed is that the tax benefit is not 19 or $21. It is only the after tax interest on the $19 or $21 for the time the benefit is actually used against positive tax earnings while the policy is in effect.

There are undoubtedly some companies with enough positive tax earnings to fully utilize the benefit. It seems more likely the anticipated tax benefits are more illusory than real.

MR. PEABODY: My comments today deal with the recent withdrawal and mortality experience on term insurance, and the impact of that experience on the amortization of acquisition costs, or more simply, profits. Please be aware that my search for current experience has not been exhaustive, and, in fact, I hope some of you will add to what we already know during the question and answer period. Any solutions to the current poor experience are certainly welcome.

Withdrawal Experience

In looking at "what's happening out there," let us look first at what was expected a few years ago when the current term products were being developed. Then what was feared might happen given the product designs, and finally what has actually happened.

In retrospect, much of our pricing a few years back was based on a combination of optimism and ignorance - optimism that past trends would continue despite dramatic design changes and ignorance of what would result if patterns changed. Withdrawal assumptions in term pricing of 15%, first year, 12% second year, and 10% thereafter, were not uncommon. The aggregate LIMRA data on term insurance at that time fell in that range.

Being the conservative people that we are, and recognizing the potential for selection, we started utilizing "worst case" scenarios in our profit tests. Withdrawal rates of up to 25% in the first year, grading to an ultimate of 15% seemed reasonably conservative to many of us.

So, what has really happened? In many cases, almost unbelievable results. First year lapse rates have exceeded 35% to 40%. And that may be the good news. The bad news is that on some select and ultimate or re-entry type products, the renewal lapses appear to be nearly as high or higher.

One company actuary I talked to indicated an aggregate (all duration and plan) term lapse rate in 1982 nearly 1/3 higher than the prior year. On some plans, a level 30%-35% rate appears to be emerging.

It does appear that the withdrawal experience varies considerably company by company, but in all cases the trend is unmistakably up! Generally, better (not good, but better) lapse experience is exhibited by companies such as life affiliates of property/casualty companies, often selling through the property and casualty agents. Often, these companies have been able to utilize lower and more levelized commission scales as a deterrent to rewriting. The same pattern may emerge as more large mutuals with captive agency forces enter the market. The worst experience seems to have been in the large size, competitively priced brokerage market, which certainly could be expected.

Another company that we studied exhibited rates that increased substantially by band - on the range of a 3 to 7 percent difference as the band size increased. Also, it was obvious that the experience in the most recent year or two was substantially different than that of three or four years ago.

Mortality Considerations

When it comes to mortality experience, comparing actual to expected, actuaries seem to have a knack for falling back on the easy out of "not enough exposure exists . . . it is too early to tell." I sometimes wonder when, if ever, enough experience will exist. Preparing for this presentation was no exception. I really was not able to find any credible experience on the recent vintage term policy.

So - knowing what we do about the marketplace and the withdrawal rates, let us guess what the ultimate results will be.

First of all, what helps contribute to mortality experience being close to or better than expected?

- Consistent or more stringent underwriting.
- Static medical limits.
- Consistent base of insureds.
- Reasonable persistency patterns - mixture of good and bad risks remain in force.

Relating these constraints to the recent marketplace for our term products, what has varied?

- Underwriting has diminished. Table shaving is common.
- Non-medical limits have increased tremendously.
- Insureds have been divided into more specific risk classifications, such as smokers and non-smokers.
- Persistency has dropped substantially.

What specifically does the drop in persistency mean? Start with two identical blocks of insureds, with one exhibiting lapses at a 20% - 15% - 10% pattern and the other at 40% - 30% - 25%. Let us also assume that 75% of those withdrawing each year are select lives and do so to take advantage of lower select term rates. After 5 years, the anticipated mortality on those remaining persons in the high lapse group could be nearly 10% greater than the other group. After 10 years, the mortality could be 50 per cent greater. How many of you built that kind of increasing mortality into your term rates?

Now is the picture really as bad as I have painted it? Probably not for most of us, but for some it is. And for those unlucky companies, they can only be thankful that they did not sell more term insurance than they did.

Profitability

To me, the impact of withdrawal and mortality experience on the amortization of acquisition expenses can be narrowed into one word - profits! What does the current experience mean in terms of profits? Alternatively, for this business which we are working so hard to develop and for which we are spending so much time and money, what are we going to get?

In order to explore the impact of experience on profits, let me show you the results of some standard profit tests. I am not going to go into the underlying assumptions, because what I am mainly interested in is the relationship of the results under different scenarios, not necessarily the magnitude of the numbers.

I have concentrated mainly on changes in the withdrawal rates, and the impact of coinsurance on a company's intended result. Poor mortality experience will make the results even worse, but as you know, it is too early to tell what is going to happen in this regard!

Slide 1 shows our basic test. Results are shown for a "moderately competitive" graded premium whole life at ages 35 and 55. The lapse assumption was one consistent with some pricing done 3 or 4 years ago, and was based on LIMRA term results. The scale was 15% graded down to 10% and remaining level. At both ages break-even occurred about the same time. Profits expressed as a percentage of premium were in 7% - 10% range. Surplus drain in each case is substantial.

Now look at the results as the lapse assumption worsens (Slide 2). The middle scale assumes 25%, 20% and 15% thereafter. The high lapse assumption was 40%, 30%, 25% and 20% thereafter. (Which still may be considered optimistic in some companies.) Look at the profits deteriorate!! Age 55 still shows some 10th year profits on the moderate scale, but none at the high scale.

None of these tests has assumed increased mortality due to high lapses, but it certainly would be a reasonable assumption.

So what can these companies do to remain in the market with a questionably profitable product? Enter the reinsurer!!

SLIDE 1

## A.R.T. PROFIT RESULTS

NO REINSURANCE

| ISSUE AGE | SURPLUS (% PREM.) | BREAK-EVEN | 10 YR. PROFIT (% PREM.) |
|---|---|---|---|
| | I. LOW LAPSE | | |
| 35 | 219 % | 9 YR. | 7% |
| 55 | 191 | 8 | 10 |

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SLIDE 2

## A.R.T. PROFIT RESULTS

NO REINSURANCE

| ISSUE AGE | SURPLUS (% PREM.) | BREAK-EVEN | 10 YR. PROFIT (% PREM.) |
|---|---|---|---|
| | I. LOW LAPSE | | |
| 35 | 219% | 9 YR. | 7% |
| 55 | 191 | 8 | 10 |
| | II. MODERATE LAPSE | | |
| 35 | 219% | >10 YR. | (2)% |
| 55 | 191 | 9 | 5 |
| | III. HIGH LAPSE | | |
| 35 | 219% | >10 YR. | (19)% |
| 55 | 191 | >10 YR. | (3) |

SLIDE 3

## A.R.T. PROFIT RESULTS

| ISSUE AGE | SURPLUS (% PREM.) | BREAK-EVEN | 10 YR. PROFIT (% PREM.) |
|---|---|---|---|
| | **I. LOW LAPSE** | | |
| No Reinsurance | | | |
| 35 | 219% | 9 YR. | 7% |
| 55 | 191 | 8 | 10 |
| Low Allowances | | | |
| 35 | 143 | >10 | (3) |
| 55 | 80 | 7 | 7 |
| | **II. MODERATE LAPSE** | | |
| No Reinsurance | | | |
| 35 | 219% | >10 YR. | (2)% |
| 55 | 191 | 9 | 5 |
| Low Allowances | | | |
| 35 | 143 | >10 | (10) |
| 55 | 80 | 8 | 5 |
| | **III. HIGH LAPSE** | | |
| No Reinsurance | | | |
| 35 | 219% | >10 YR. | (19)% |
| 55 | 191 | >10 | (3) |
| Low Allowances | | | |
| 35 | 143 | >10 | (23) |
| 55 | 80 | 10 | 1 |

SLIDE 4

## A.R.T PROFIT RESULTS

| ISSUE AGE | SURPLUS (% PREM.) | BREAK-EVEN | 10 YR. PROFIT (% PREM.) |
|---|---|---|---|
| **I. LOW LAPSE** | | | |
| No Reinsurance | | | |
| 35 | 219% | 9 YR. | 7% |
| 55 | 191 | 8 | 10 |
| Low Allowances | | | |
| 35 | 143 | >10 | (3) |
| 55 | 80 | 7 | 7 |
| High Allowances | | | |
| 35 | 125 | 10 | 1 |
| 55 | 60 | 4 | 11 |
| **II. MODERATE LAPSE** | | | |
| No Reinsurance | | | |
| 35 | 219% | >10 YR. | (2)% |
| 55 | 191 | 9 | 5 |
| Low Allowances | | | |
| 35 | 143 | >10 | (10) |
| 55 | 80 | 8 | 5 |
| High Allowances | | | |
| 35 | 125 | >10 | (5) |
| 55 | 60 | 4 | 10 |
| **III. HIGH LAPSE** | | | |
| No Reinsurance | | | |
| 35 | 219% | >10 | (19)% |
| 55 | 191 | >10 | (3) |
| Low Allowances | | | |
| 35 | 143 | >10 | (23) |
| 55 | 80 | 10 | 1 |
| High Allowances | | | |
| 35 | 125 | >10 | (15) |
| 55 | 60 | 5 | 7 |

This next slide (Slide 3) shows profit results for the same three situations, but assumes a coinsurance agreement exists with moderate allowances, those being 100% first year, 30% second year and 20% in years 3 - 10. These allowances are about 10% above the assumed commission scale.

What happens to profits? At the low lapse assumption age 35, even this arrangement does not help. The savings in surplus strain is not enough to make up for the shifting of profits in renewal years. At age 55, break-even occurs earlier, but 10th year profits are still about 3% lower.

As lapses increase, age 55 begins to look more profitable to the direct writer. It now breaks even quicker, and 10th year profits are comparable or better than if no reinsurance is assumed. Age 35 is still a loser.

What is the answer? Milk the reinsurers for even higher allowances (Slide 4). Does it brighten the profit picture? You bet! Using the low lapse rates, age 35 now shows a 10th year profit. Age 55 anticipates greater profit results than with no reinsurance. The same picture holds true as lapses worsen. The reinsurer is absorbing the risk, bailing out the direct writer, and virtually eliminating the need for the writing company to be concerned about persistency.

When looking at these results, it is necessary to keep in mind that they are pre-tax, so no 818(c) adjustment has been made. Also, the premium pattern and profit test assumptions are generalized, and will not match those for your specific company. But the results have not been doctored. They just fell out by changing lapse assumptions and combining different coinsurance allowances. I would not expect the various relationships to be too much different for any competitive term product in today's marketplace.

MR. HALSTEAD: We have recent lapse experiences which may be of interest.

Overall our average annual lapse rate for the last 5 years has been just under 20%. The year by year trend, though, has been up during the 5 years. The annual rates have increased from about 12% in 1978 to about 24% in 1982.

Lapse rates vary significantly depending on the characteristics of the policies written. Rates for Deposit Term, for example, are less than half the rates for ART type policies. Rates for small policies are 50% lower than for large policies. Rates for smoker - non-smoker distinct policies seem to be significantly lower than for composite policies, although it may be too early to tell for sure. Rates for standard policies are better than on substandard. Rates on pre-authorized-check modes are better than on billed modes. Rates on business written by non-life producers (casualty agents, stock brokers) are generally better than business written by life producers.

Our latest study is based on $12 billion of lapses on $60 billion exposed and covers 5 policy years. Almost half the exposure is in the first policy year. Rates, while higher in the second policy year, are remarkably similar for each of the 5 years.

With respect to mortality, we have no new statistics.

Trends in Product Design

My comments cover trends in product design, which is the first of 3 subjects in the program relating to term insurance. These comments follow the outline and cover (I) the current environment, (II) interaction of term with Universal Life and other non-traditional products and (III) the future of term insurance as I see it.

The first thing I would like to do is define term insurance as any kind of life insurance that has little or no investment element for some period of time. That way I can talk about graded premium whole life policies and modified premium whole life policies and even minimum deposit whole life policies as though they were term insurance. A substantial amount of the "term" business written today is written on non-term policy forms.

I The Current Environment

The term insurance environment today is in what I would categorize as a state of reassessment. While the reassessment at this point is far from complete, emerging facts are suggesting new directions. It seems likely some significant changes will result.

Over the last few years we have all witnessed growing sales, rapid changes in policy design, tougher and tougher competition, the development of select and ultimate rate structures, the introduction of indeterminate rates, the introduction of smoker - non-smoker rate differentials and bigger and bigger reinsurance allowances.

In my opinion, the prospects of large volumes of sales, large tax benefits, and in the case of direct writing companies, attractive reinsurance terms, had led to a state of euphoria. Some recent facts have deflated the balloon somewhat.

On the positive side, term sales have continued to be strong, and do not show any sign of slowing.

On the negative side tax benefits no longer seem so certain, persistency of term business has deteriorated, mortality margins seem thin and as a result of these negatives reinsurers have gotten a lot more conservative. In short the profit picture for term insurance, based on current products and pricing, looks bleak.

The tax benefit that seemed to be fueling the excesses in the term area is the 818(c)(2) approximate revaluation allowed under the 1959 Tax Act. Pre-Stop Gap, a $21 per $1,000 deduction was permitted for whole life insurance. The availability of this deduction led to the development of a variety of whole life policies containing no investment element for some period of years (earlier defined as term). The most popular product was a graded premium whole life policy in which gross rates were approximately proportional to select and ultimate mortality rates. Stop Gap legislation reduced the $21 to $19, which was not particularly significant; but the Senate Finance Committee Report dealing with Stop Gap questioned the applicability of either $21 or $19 to graded premium policies. This was significant since it indicated Congress intended to eliminate the tax benefit that was making the current term environment viable.

The negative tax signal immediately caused some reinsurers concern. Within a short period of time they were reducing allowances under coinsurance treaties. They either cited directly the reduced or perhaps eliminated tax benefit or poor persistency.

Persistency on term, particularly select and ultimate term and older term policies that did not differentiate between smokers and non-smokers, has deteriorated recently and is causing significant problems for some reinsurers. Poor persistency has hurt direct companies as well, but lapse ratios seem to be a lot worse for larger policies. I have been told that in the current environment annual lapse rates as high as 40% are not uncommon.

While persistency is the problem everyone recognizes and is talking about, a more fundamental problem in my opinion is the mortality margin. Most companies seem to have switched from composite rates to separate smoker and non-smoker rates. At the same time they have switched from long term to short term rate guarantees. In some cases the mortality assumptions used for non-smokers seem particularly aggressive. The difference in smoker and non-smoker premium rates for term insurance is dramatically greater than for permanent insurance and seems certain to affect the credibility of underwriting. Smokers will either lie to get non-smoker rates or they will buy composite rate policies. Either way mortality assumptions are defeated. Furthermore reliance on long term rate corrections after short term guarantees run out is not worth much based on current lapse rates. In addition to the short term mortality problem there may well be a long term problem if ultimate gross rates do not adequately cover almost certain adverse selection.

To summarize again the current term environment, we have on one hand, a strong demand which is reflected in sales. On the other hand, we have problems with persistency and perhaps with mortality. We also have tax problems and reinsurance problems.

## II Interaction with Universal Life and Other Non-traditional Products

My comments in this area are for the most part limited to our own experience, which is with required premium Universal Life policies. Our U.L. policies are unbundled policies but they do not have pour-in or stop-and-go privileges, and, if stipulated premiums are not paid they lapse like conventional policies. Our policies feature back-end loads, competitive select and ultimate mortality charges, and attractive current interest rates.

We have been attempting with some success to promote this product as a term alternative. In our promotion we point out that although the first year cost is higher than term the cost over a relatively short period of years is lower than term. In fact, we can illustrate for someone in the 50% tax bracket it is only half the cost of term, because of the tax-free inside interest build-up. Another aspect of this promotion relates to the fact that agents' dollar commissions are substantially higher than on term insurance.

We feel this product can readily be shown to be better for the policyholder and the agent, certainly if the term policy is not replaced each year for a new first year select rate, and perhaps even if it is. In addition to that, though, it is a sounder product from the company's standpoint than term. Substantial back end charges should encourage persistency, and in general, its earnings potential is larger.

Our approach can, of course, also be used with flexible U.L. forms. Actually the flexible forms are better adapted as term alternatives since the policyholder can directly eliminate at his option the investment element in the policy by paying annual premiums equal to the annual cost of insurance. Some product designs may require a target first year premium before this is permitted, in which case the effect is more like deposit term than conventional term. My impression, though, is that most U.L. companies are promoting the investment elements in their products and are not promoting them as term alternatives. Mortality charges, in fact, in most U.L. products do not seem to be particularly competitive with rates available in term policies.

## III Future of Term Insurance

While we are optimistic that Universal Life can be promoted as an alternative to term insurance, we are certainly not optimistic enough to abandon term policies altogether. We might feel differently if we were promoting a flexible premium U.L., but I think not. U.L. is a complicated product to describe to customers compared to term and is not comfortable to many agents and policyholders.

From our perspective there seems to be an undiminished demand for term. However, changes are required for the reasons enumerated earlier. The immediate changes I see seem to focus on a resolution of the persistency problem. Level commissions is one short run change that seems likely. In the long run, though, some structural product changes seem more likely.

It would not be surprising to see a general retreat from select and ultimate rate structures to aggregate rate structures. On the other hand, select and ultimate rate structures might be continued in deposit term forms. A somewhat similar idea is apparently popular in Canada where a first year underwriting charge is made on top of select rates. In any event, if select and ultimate is to continue on a sound basis the company needs to be immunized against the lapse risk using deposit term type techniques.

Premium rates for term insurance seem to have stabilized. In view of current problems it seems unlikely they will reduce further unless sales and underwriting costs can somehow be stripped out. It is possible rates may even start increasing; although it is likely rate increases will be masked as much as possible by use of new policy forms.

Other reasons for higher premium rates, of course, are the anticipated elimination of tax benefits and reduced reinsurance support. It should be noted though that reinsurers in general continue to be very competitive if their persistency risk is reduced sufficiently.

Crystal balling the future of term is speculative, to say the least. With changes needed and continued demand there would seem to be interesting

opportunities for imaginative approaches which should add an interesting dimension to future competition in this business.

MR. JOHN M. BRAGG: Over the last 4 years, our organization has prepared very detailed non-smoker and smoker mortality tables. From this background, I have the following comments:

(1) Many companies are not charging high enough mortality costs for smokers;
(2) Companies need to sharpen their underwriting practices, in order to secure the non-smoker mortality costs which they are charging;
(3) We need to pay particular attention to the substandard non-smoker - particularly the recent quitter. It appears that the effect of smoking seems to take about 10 years to wear off, whereas most companies are using a one year rule;
(4) We need to pay attention to the "misrepresentation" phenomenon, and develop appropriate defenses. From estimates that I have heard, between 3% and 15% of the smokers are misrepresenting their status.

MR. MELVILLE J. YOUNG: I was interested to hear some of the remarks regarding 818(c)(2) benefits. I wish that I could say for myself and my brethren in the reinsurance commmunity that some of the irrational behavior to which you have referred could be explained by our assuming that we had some 818(c)(2) benefits in these products. I have found very few reinsurers, if any, that believe there is any 818(c)(2) benefit generally available in any of the graded premium whole life products. I think there are a handful of companies that have structured their products to produce, perhaps, a reasonable argument for some benefit, but certainly not $19 or $21. Most graded premium whole life products have negative terminal reserves, and therefore, most companies are reserving on half of cx, which most actuaries consider to be Net Level. In fact, a few tax related decisions would indicate that these products are considered Net Level. I am not aware today of any reinsurer that is justifying its action with the 818(c)(2) benefit. In fact, at least one major reinsurer has an 818(c)(1) election. I wish that I could say that is the reason, again, for our irrational behavior in recent years. I do not think it is.

MR. PEABODY: As we look back on what has happened in the term market in the last few years, it is really easy to point the finger and maybe to accept blame. I really do not think it is completely justified. I certainly can not blame reinsurers and did not mean to imply that reinsurers have been the cause of some of the things that have happened. They have just been another piece of the whole pie. They are not causing the poor persistency, nor causing the poor mortality, nor creating the more lax attitude of some of the direct writers. Certainly there is joint blame, if in fact, blame is the right word. I do continue to hear people say "we have to do something" instead of "we are doing something". We have been saying this for the last few years, and we are still saying it. I hope that in the near future we will be able to say that we have done something.

MR. YOUNG: To follow up on what you just said, one of the primary purposes of yesterday's conference (joint meeting of the Reinsurance and

Individual Product Development Sections to discuss term insurance) was to show that there are a number of companies that have begun doing something to address some of the problems you discussed. They talked about some of the actions that they are taking. I am aware of several other major term writers that are already doing something. It is inevitable that we as professionals will not continue accepting losses for our companies forever. I did not mean my earlier comment to imply that I thought you were saying something negative about reinsurers. I think we do deserve our quota share of the blame for what has happened, and I hope that we will also do our part towards helping to correct the problems.

MR. MARTIN: Lynn asked me to mention a couple of things that Lincoln has been doing in this area.

One, I mentioned our lapse experience in our general analysis. We have made some significant changes in our pricing approach to the select and ultimate term market. We hope the changes we have made are conservative enough for what is actually going to happen. The lapse rate, in and of itself, is not critical if you have priced for it.

In addition to altering our posture on new quotes and changing our pricing approach, we have reviewed existing arrangements and, in a number of instances we have attempted to either renegotiate them or terminate them if possible.

Another specific thing we are doing relates to the large case market. A reinsurer is somewhat limited in having an effect on persistency because there is no direct relationship with the agent or the policyholder. One of the areas in which we can have some impact is our facultative business. We have established a policy that, when we receive a facultative application in which the case has been the first replacement in two years or the second time in five years, we will not make an offer with, for example, a 100% year coinsurance allowance or a zero RPR rate. We will quote an RPR, YRT type premium. Again, our approach is that we are interested in reinsuring that risk, but we feel strongly that pricing has to match the risk we are taking.

MR. FRED TOWNSEND: Has anybody ever made any lapse study based not upon plan of insurance, or face amount, or issue age, but based upon percentage change in the premium rate at renewal on ART? It seems to me the lapse problem results from these 50 to 60% increases in premium rates in the second year on select and ultimate plans. If a company had a sound product design it would be increasing the premium rate by only 10 to 15% a year.

MR. PEABODY: I am aware of one company that developed a competitive product 3 or 4 years ago, priced with a level premium for the first 3 years and then an increasing premium thereafter. Their first and second year experience has been much lower overall then what I have seen in the industry on this type of product. They are still very heavily selected against by size - the difference between their lapse experience by policy count and by amount is close to 20 percentage points - even with the early level premium. They fear what is going to happen at the end of the 3rd year when they get the big premium increase.

MR. STEVE SMITH: I have a pet theory, and everything that I have seen seems to support it, that the lapse rate on term products is composed of two pieces. The first piece is the lapse that results from all reasons other than a premium increase. These reasons would include: no need for the insurance, the insured's company went bankrupt, or difficult economic times. The second piece is directly and solely related to the percentage increase in premium per thousand in force. The magnitude of this piece is a percent in the range of 70-90%, say 80%, times the percentage increase in the premium. For example, if you have a policy with a 50% premium increase (and some of these very steep select and ultimate scales do) and you are assuming an intrinsic lapse rate of 10%, my formula would imply a lapse rate of 10% plus 80% of the increase in premium, or 10% + 40% = 50%.

This formula works very well on our five-year R&C, on our decreasing term, and on our attained age YRT. The studies that I have done give a very strong indication that lapse rates are related to premium increases.