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INDIVIDUAL LIFE INSURANCE AND ANNUITY PRODUCT DEVELOPMENT SECTION—SELECTED TOPICS

Chairperson: GREGORY J. CARNEY. Panelists: DAPHNE D. BARTLETT, DONALD W. BRITTON, WILLIAM B. HARMAN, JR., JOHN J. PALMER. Recorder: GREGORY J. CARNEY*

This session will deal with current topics in an open environment. The topics will include the following:

1. Implications of UNISEX legislation and the Norris Decision

2. Impact of the proposed tax law

3. Variable products, including Universal Life Phase II

4. Large Amount Term Insurance persistency and mortality effects on cost

An Open Workshop is a new concept in the format of the session at the Society meetings. Although the session was non-recorded, our discussion leaders have provided us with a summary of their initial remarks. This summary follows.

MS. DAPHNE D. BARTLETT: Since most of you are probably already over-unisexed, I have decided not to go into too much detail on the specifics of the Norris Decision or HR100/S372. Instead, I will talk a little about why I think it is important for actuaries to continue to oppose unisex, what we might consider in order to discourage the passage of the legislation, and some things we should be thinking about if we are fortunate enough to prevail.

The proponents of unisex believe it is a civil rights issue. They say that women and men should be treated equally in everything, no matter what the economic impact. This is a hard argument to refute. But, if unisex insurance is required under civil rights principles, then I think it is inevitable that our practice of reflecting age or state of health in insurance underwriting will also eventually be challenged under the same principles. The private insurance industry can survive under unisex: I do not think it can under uni-age or uni-health.

How can we respond to the "civil rights" argument? I have thought of two ways. The first is the idea that we actually do treat people as individuals when they apply for insurance - we ask their age, their state of health, whether or not they smoke, etc. - to not reflect their gender is treating them less like an individual than the current system, and thus is violating their civil rights. The second is the concept that, in our society today, there are certain areas where it is acceptable for one person to be treated differently from another. We do not have unisex public restrooms; women are not required to register for the draft; senior citizens frequently obtain

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discounts in restaurants or at the movies. Because it is unique, is not insurance another area where differences should be permitted?

Today, some companies are developing unisex annuities for the non-Norris marketplace. No doubt, unisex life insurance policies will be coming soon. Does this mean that the battle is over, and we should give up? I do not think so. A company offering sex-distinct rates can probably compete quite successfully with a unisex company. Under mandatory unisex, I am very concerned that non-participating insurance will disappear from the marketplace because of the inability in such plans to adjust for incorrect estimates of the gender composition of sales. This, of course, can be reflected in the dividend scale under participating policies.

Where are we today, politically?

1984 is an election year, and the gender gap is looming large. But things are not impossible. Remember where we were last March. I was told then, by our company's lobbyist in Washington, that there was not one lobbyist, including him, who thought there was a prayer of defeating, or even modifying the unisex legislation. We have made a lot of progress in educating the Congress, and the general public, about our side of the story, and we are getting through.

Women do not want to pay more for their life insurance or their auto insurance.

But women do, I think, want equal pensions as a result of their employment.

Norris goes part of the way towards providing them. Instant, full equality in pensions, though socially desirable, is severely damaging to cities, employers and insurers. There has been some discussion about the concept of some limited retroactivity in pensions - back to Manhart, for example. there is concern over this in the insurance industry, because it could provide a stimulus for retroactivity in life insurance, which just about everyone, including the Congress, views as a disaster.

An alternative which I find interesting is what I call "prospective full equality". This approach would require full equality in pension benefits at some time sooner than the 30-35 years it will take under Norris. In, for example, 15 years, all pension payouts would be equal. The advantage of this appraoch is that the transition can be planned and funded.

I believe strongly that actuaries should continue to actively oppose the provisions of the federal legislation which mandate unisex for individual contracts. However, I also believe that, if we prevail, we should use our influence to make sure that we really are treating all our applicants fairly and consistently. I am not convinced that is universally the case today.

It certainly is easier and less expensive to determine someone's gender than it is to perform a smoking test. But this is really one of the things our critics are saying - why should we use gender, which is conveniently available, and not use everything else? I think we should listen, even if we do not like what we hear. Preservation of the principle of risk classification in private insurance is too important for us not to.

Please think about the following questions:

Is it fair to issue policies to smokers and non-smokers at the same rates, but still reflect the sex differential? Smoker/non-smoker differentials are greater than sex differentials at many ages.

What about mass marketing, and "absorbing some extra mortality"? Is it fair to ignore significant health evidence, and still have rates which vary by sex?

Why are we still using a constant setback at all ages? It is convenient, but is it really fair?

And what about annuities? Why are gender and age the only risk factors we consider? If you are about to answer that substandard people do not buy life annuities, then what about all those men who are substandard, at least as far as their mortality relative to women is concerned? Not to mention all those smokers and non-smokers.

Why do we continue to flaunt the fact that we pay different annuity amounts, or charge different premiums to men and women? I bought an IRA from my own company and became incensed at the apparent sexism of the settlement options. Surely someone with a little imagination could figure out a way to make a policy form provide different annuity amounts to men and women without waiving a red flag in front of the National Organization For Women!

Why does every advertisement for life insurance show male and female rates?

Why not just male rates, unidentified. After all, an applicant may not get the rate advertised if he or she turns out to be substandard.

Social change is usually instituted as a result of extreme positions. The resultant change is somewhere between the status quo and the extreme. I think that this is what is happening here. We do not have a hope of preserving the status quo. But perhaps, if we are willing to change a little, we can avoid the extreme.

MR. DONALD W. BRITTON: Let me begin with a definition of Term Insurance for the purpose of this discussion. In addition to traditional term policies such as A-R-T, Five Year R&C and Level Term, my discussion of Term Insurance includes a policy which has created turmoil in the insurance industry - the Graded Premium Whole Life policy. In case there is someone left in our industry who is not familiar with this product, I will give a brief description. Graded Premium Whole Life provides insurance to age 100 with a very low premium in the first year, increasing rapidly every year for 10 to 20 years at which time it remains level for the remainder of life. There are companies selling this product as low as $0.57 a thousand. Compared to the typical A-D rate of $1.00, you can see how low this premium is.

Perhaps the best way to address the effect of mortality and persistency on cost would be to provide each of you with some statistics on mortality and persistency and let you draw your own conclusions on their effect on cost.

You would think that the most important cost of pricing consideration in a term policy would be mortality, however, the ultimate level of mortality and its effect on cost, as I see it, will be greatly affected by persistency. With this in mind, I would like to begin with a discussion of persistency.

Lapse rates need to be considered under two types of term policies. The two types of term policies are distinguished by the nature of the rate scale. For sake of discussion, let us designate category one, Term Policies, as Select and Ultimate (these include Graded Premium Whole Life) and category two, Term Policies, as Aggregate Rate Policies, i.e., new issue rates and renewal rates are equivalent.

Let us begin our discussion of persistency with the select and ultimate, category one, type of term policy. I would like to provide you with some general comments and statistics on lapse rates.

1. First year lapse rates range from low 20's to the high 30's.

2. Second and later years range from high 20% to low 40%.

3. Unlike traditional situations, lapse rates grow worse by duration and, typically, are higher for older ages than younger ages. The reason is probably linked to the fact that increases in the term rate from one year to the next is far greater at the older ages, and there appears to be a strong connection between the increase in the term rates and the lapse rate.

4. Lapse rates worsen as policy size increases reflecting the selection by the more sophisticated buyer. There is as much as a 10 percentage point difference in lapse rates for small versus large policies.

Lapse rates for the aggregate rate (category two) term policy have similar, but not identical patterns.

1. Lapse rates have increased significantly over the past 3 years.

2. Lapse rates, 3 years ago, appeared to be almost level by duration and in the range of 15% to 20%.

3. Currently, lapse rates, after the first year, still appear to be level but in the range of 24% to 30%. First year rates are in the low 20% range. Reasons for this increase could be attributed to the introduction of smoker/non-smoker policies and smokers seeking the lower non-smoker rates, or policyholder changing to select and ultimate rates with intentions of replacing the policy every year or so. If lapses are due to smoker/non-smoker changes, they should begin to decrease some as more policies are changed to non-smoker for at least the non-smoker category.

4. Again, lapses increase as policy size increases, reflecting the poorer persistency inherent in the large policy.

As I indicated earlier, persistency should have a significant affect on mortality, and I would like to discuss this further, but first I would like to make several comments about mortality on category one policies in general.

1. Recent mortality experience has been much worse than expected. Reasons given for this worse than expected mortality include:

i. Liberal underwriting.

ii. Hard times.

iii. Speculation due to low premiums.

iv. Increased number of cases involved with the introduction of the product (overload underwriter).

2. According to one reinsurer, violent deaths are significantly high.

Mortality on category two (aggregate term policies) for my own company, has been, up to this point, better than expected. However, with the increase in lapse rates, I would expect that mortality in the future should worsen.

This brings me back to a point that I have alluded to twice and that is persistency should have a significant affect on mortality. I feel it is too early to tell what mortality will be like in the future of term insurance in a poor persistency environment. The jury is still in deliberation on the mortality case. We have been, at best, guessing as to what future mortality, after the early durations, will be like, especially on category one term policies, which are experiencing very high lapse ratios. I suggest to you that persistency will be the key to the jury's verdict on mortality and ultimate cost to the insured and ultimate profit or loss to the company. The reason that persistency plays such an important role in future mortality cost of a term policy can be seen in the following comparison.

In the early years of a term policy, lapses result in a loss since acquisition cost has not been recovered. In later policy years, increased lapse rates generally result in anti-selection and poorer than expected mortality experience, since an inordinate proportion of the "lapses" will be select, and those whose health has deteriorated will tend to persist. Unlike the whole life policy where a replacement at a higher age will result in a higher premium and a change in cash value growth, term insurance replacement can frequently be effected for a reduction in premium and no apparent loss of other benefits.

Now that I have given you a picture of what mortality and persistency patterns are like, I would like to provide you with my crystal ball analysis of what effects current persistency and mortality will have on cost of large amount term policies.

1. Very low first year rates available on select and ultimate products with high first year commission and a very steep rate scale in renewal years will have the following effect.

   a. In the short term, encourage high lapse rates and tremendous cost to the companies involved because they will not be able to recoup acquisition expenses.

   b. In the long run, the anti-selection effects I discussed earlier could leave the company with tremendous mortality cost for lives that remain because the healthy lives have gone elsewhere and the unhealthy persist.

c. The cost to the insured is fine as long as he can get a new policy each year. However, if there is a change in health, he may be stuck with a very costly rate, and if the rate is not guaranteed, the company may increase the rate later to cover their increased mortality cost, thus increasing the insured cost even more. With this in mind, I think that first year rates have bottomed out, and the cost to the insured will increase significantly.

d. As lapse rates continue at high levels, reinsurance companies will continue to drop out of the market or cut allowances, making large policies more expensive or even impossible to obtain.

2. Aggregate rate policy with high first year commission will have the following effect.

   a. It should create less incentive to the insured to change for a new first year rate, however, high first year commission means heavy cost for the lapse.

   b. The cost to the company could vary greatly depending on future mortality and persistency patterns.

   c. The cost of the insured on the aggregate rate term policy should remain the same and may even be set at a lower rate as companies switch from select and ultimate back to aggregate rate policies.

In conclusion, the need for term insurance, in large or small amounts, will continue to be a big market. However, policy designs or marketing approaches that do not support policy persistency can create grave cost consequences to the company, and possibly the agent and the insured. Ralph Waldo Emerson said, "Shallow men believe in luck; wise and strong men in cause and effect." I think the future of the term market depends on our being able to be both wise and strong and admit that some of our current product design is bad. I think product designs in the future should incorporate some of the following features.

1. No banding for large policies to reflect poorer persistency as policy size increases.

2. If products are to remain select and ultimate, first year compensation will need to be completely or partially levelized and first year rates increased.

3. Introduce noncommissionable policy fees.

4. Incorporate first year underwriting fees to offset first year cost; along with a competitive aggregate rate scale and some levelizing of commissions.

5. Design products to have a level rate for a number of years with a reduced first year commission that in total dollars pays more commission to the agent but provides the company with revenues to defray the cost of high lapses.

6. Implement, with new products, underwriting for persistency. This would require the company to decline a case that has a history of replacement or issue the case with adjustments in commission.

In our endeavors to create innovative life insurance products, poor persistency and bad mortality may be a painful or expensive reminder that product innovation may be very costly when sound product design fundamentals are ignored.

MR. JOHN J. PALMER:

A. Variable Annuities: Recent Interest in Real Estate-Related Non-Qualified Products.

   1. Unregistered approach

      a. Invest only in non-securities real estate (fee interests, purchase leasebacks, mortgages)

      b. Advantages:

         (1) Can limit withdrawals
         (2) Avoid daily valuation
         (3) Can borrow without limit
         (4) Approval by contractholders avoided
         (5) Can deal jointly with affiliates

      c. Problems:

         (1) Higher expenses
         (2) Must avoid any "securities" investments
         (3) Diversification more difficult
         (4) Liquidity problems

   2. Registered approach

      a. Invest in mortgage pass-through certificates, REIT's, etc., which are liquid real estate-related securities

      b. Advantages:

         (1) Avoid uncertainty of treatment
         (2) Better liquidity and diversification possible

      c. Problems:

         (1) Borrowing restrictions
         (2) Voting by contractholders
         (3) Exemption needed for affiliate transactions
         (4) High liquidity required

B. Variable Life Products

   1. General: Tax law changes (proposed)

      a. Life reserve treatment

b. Capital gains double taxation

c. Definition of life insurance

d. Dividends: possible problems for mutuals

2. Traditional

a. Rapid increase in entrants into market

b. More product variation (single premium contracts, wider fund variety)

3. Universal Form

a. 6 - e - 2 proposed exemption filed with SEC, action expected late spring/early summer of 1984

(1) Extends 6 - e - 2 to flexible premium forms
(2) Sales load limits based on "guideline level premium"
(a) Front-end load as basic test
(b) Back-end load allowed on "same or better economic value" theory.

b. State model law for variable universal

(1) Approved by NAIC
(2) Slowly working its way through states

c. State securities regulators

(1) Possible problems: recently have been attempting to assert more authority over insurance
(2) Should be watched closely

d. Future of product

(1) Early design likely to be clones to general account designs (because of systems constraints)
(2) Later designs: variations in load structures, subsidiary guarantees, riders
(3) Outlook: probably distribution system bound (limited number of enthusiastic registered representatives), hence growth not as explosive as general account UL.

Following Mr. Palmer's presentation, Mr. Harman led an indepth discussion on the new proposed tax bill and its implications to insurance products. Mr. Harman also provided insight into the internal lobbying effort that has been a part of the Congressional effort.

After Mr. Harman's presentation, questions and discussions with the members of the panel and the audience proceeded. There was an expansion of many of the ideas presented by the panelists as well as the introduction of new topics by members of the audience.