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CURRENT INDIVIDUAL TERM PRODUCT TRENDS

Moderator: DOUGLAS DOLL. Panelists: ROGER R. HEATH, P. RANDALL LOWERY, MICHAEL R. WINN. Recorder: DAVID A. SCHOFIELD

1. Current Trends in Term Product Design
2. Term Insurance: Reinsurer's Point of View
3. The Future of Term Insurance

MR. DOUGLAS DOLL: Let me briefly introduce the panelists. Roger Heath is a consultant with Tillinghast, Nelson & Warren. Randy Lowery works for Protective Corporation in Birmingham, Alabama. One of the companies owned by Protective Corporation is Empire General. Empire General is one of the first companies to introduce select and ultimate term rates and the first company to offer nonsmoker select and ultimate term rates. Michael Winn, from Business Men's Assurance (BMA) in Kansas City, will present the reinsurer's point of view. BMA was the first reinsurer to publish the results of their ART persistency experience, and they are one of the first reinsurers to take positive steps to try to improve their persistency experience.

Those of you who have been following term insurance closely will probably notice that our outline for today is nearly identical to the outline for the open forums that were held in the Spring meetings last year. To some extent we are going to update the presentations that were given a year ago. On the other hand, a year ago the persistency for term insurance was just starting to be made public, and most of the suggestions were merely recitations of how bad the experience had been and "let's do something". Now we have had a year and perhaps we can see or get some examples of what companies actually have done.

Before coming to this meeting, I looked at the March issues of Best's Review and Life Association News. Neither magazine had a single ad that presented term insurance rates. There was one agency in Life Association News that stated "cheap term", but it did not give a company name or any specific term rates. That is a far cry from two years ago when it seemed like every issue of an industry magazine had several ads that presented term rates.

In the new policy section of Best's, there were several companies introducing Universal Life policies and Excess Interest Whole Life products, but no one introduced term plans.

The March issue of Best's Review also had a premium comparison; the premium comparison was labeled Annual Renewable Term. If you look closely at that premium comparison, you will see that there is at least one 10-year level premium term plan in there. Some of these plans are select and ultimate term plans. There is at least one plan that shows the premiums with re-entry assumed. So it appears that it will be fairly difficult to put a term premium comparison together that does not have apples and oranges.

P. RANDALL LOWERY: One of the speakers at a meeting of the Canadian Institute of Actuaries pointed out that we are spending three times as much time on problems as we are on solutions. It remains to be seen whether that is because the solutions are so clearcut that they can be covered in a third of the time, or whether approximately 67% of the problems have no solutions. I will try to devote at least half of my time to solutions. Although the topic is term insurance, I will include plans that operate as term from a practical standpoint, regardless of their legal definition. When we do arrive at the "open" portion of this open forum, I hope that you will volunteer information on the types of products that your company has recently introduced, or that you have seen from your competitors.

The trends in place today had their beginnings in late 1982 when the first year rate for a 35 year old non-smoker reached as low as $.50 per $1,000 on some products. The trend that had led us to that rate was to simply devise new mechanics or philosophies to reduce the first year rate, or perhaps the total rate over the first three to five years. These new devices included lower rates for non-smokers and the physically fit, select and ultimate rate structures, graded premium whole life policies, redistribution of expense assumptions between whole life and term (with a larger portion of marketing expenses considered to be a percentage of premium), reduced overhead assumptions in hopes of expanding volume, and at least a few instances of very small or zero profit margins justified by possible tax benefits associated with Section 818(c)2. Many companies also projected losses on direct business but made a profit when reinsurance was taken into account. Others assumed low volume and no profit, but wanted the product because they thought that it would attract new agents. For several reasons the then current trend in term products simply had to come to a halt, although not all of the innovations were at fault. It almost seemed as though the goal was to design a product that would terminate before the insured did.

Perhaps the first factor to slow the trend was that first year rates were approaching expected first year claims. The companies that had been accustomed to introducing a new product every six to nine months that would beat almost everything on the market (even if only for a few days) simply could not do so any longer. At about the same time poor persistency experience was beginning to emerge, reinsurers were beginning to realize that profits were doubtful or non-existent, and concern was developing about the lack of financial underwriting and the anti-selection created by the consistent availability of re-entry at a lower rate.

Finally, the trend toward lower first year rates ended in the spring of 1983, at about the same time that much of the negative data on mortality and persistency was made available in Chicago at the joint meeting of the Reinsurance and Product Development Sections. Reinsurers had already begun to sharply revise their pricing assumptions, and some refused to quote allowances on re-entry products.

The current trend in term insurance is proceeding along two paths, both resulting from the lessons that have been learned from the experience on select and ultimate products. Some companies seem to be unsure which path to proceed on, so they are taking both routes simultaneously.

The first path is keeping the select and ultimate product on the market as

long as possible. Several modifications have been made to make the product profitable or at least to cut losses. The most common of these is to restructure commission scales, typically using level or near level percentages of premium for the first two to five years. If the company varies commissions by band, the flatter commission scales are used for the large face amounts, recognizing that lapses have been higher on large policies. Non-commissionable policy fees have also appeared, sometimes larger than the policy fee that was commissionable on the same product a year ago.

Another reaction to the lapse experience varying by policy size has been the elimination of banded rates, but the intended effect is sometimes partially offset by the larger policy fees.

At least two major companies have increased rates for new issues, although not for currently in force policies. One company cited poor persistency and the other the probable loss of 818(c)2 benefits for 1984 issues as their reasons for these increased rates.

Some companies that have continued to sell select and ultimate products have retentions large enough that reinsurance allowances do not dominate the pricing assumptions while others have persuaded their reinsurers to allow them to keep the products on the market a little longer until a suitable replacement can be developed. Since marginal expense assumptions were often used in getting into this market, I suspect that they also have been used as a justification for staying there.

Even with marginal expense assumptions and level commissions, rate structures indicate that many companies are assuming that a substantial portion of the lives eligible for re-entry will not bother to apply for it. That does not seem to be a reasonable assumption on a large term policy sold to a cost-conscious consumer by an agent who is eligible for a new commission.

Many major term writers have taken the second path, which is to introduce new term products designed to minimize lapse rates and anti-selection. Several have discontinued their select and ultimate products for one or a combination of the following reasons:

1. The company actuary had felt for some time that the product was inherently flawed and was producing a loss on a direct basis, so the product had to be pulled when reinsurance was no longer available.

2. The actuary believed that poor persistency was largely due to an educated consumer who commanded the lowest rate each year, thus persistency cannot be substantially improved by leveling the agent's commission.

3. Although commissions could be levelled to the extent necessary to withstand very high lapse rates from the standpoint of recouping acquisition expenses, the actuary realized that the anti-selection risk could produce mortality ratios three to ten times the pricing assumption at some future date.

The companies that have already pulled their annual select and ultimate rate scales realize that the product has the most basic flaw. It relies on both the ignorance of the consumer and on the field force showing more loyalty to the company than to their clients. These companies have attempted to replace the new premium volume that they had enjoyed with the select and ultimate product in a variety of ways. New product introductions include deposit term, Universal Life with select and ultimate rates that can be illustrated as a term product, decreasing term, attained age Y.R.T. and other renewable term plans.

At least one major company has introduced a deposit term policy that does not pay a commission on the deposit. This is an ideal method of ensuring good persistency and the rates can be competitive with most other term products. However, there is resistance among many agents to this type of product because the additional first year premium looks very large on the jumbo face amounts. The size of the additional premium can be smaller if it is not returned in some future year, in effect charging the policyholder a non-commissionable premium that covers all or most of the marketing and underwriting costs. Although producing very favorable ten year cost illustrations, the market for a product with a large deposit will remain limited in the near future, because of all the various new designs. It differs most from what agents and consumers have become accustomed to over the last few years.

In pricing Universal Life products, it has been easy for companies to use attained age rates for mortality charges and a few have even employed "reverse" select and ultimate scales with rates by attained age actually declining by policy duration. As long as the rates are not visible in the sales proposal, these structures seem more desirable because they tend to produce higher long term cash values than do normal select and ultimate scales designed to produce the same profit margins. Nevertheless, many products do not use select and ultimate mortality charges, and I have seen one sales proposal that uses a term illustration as a basis of selling the Universal Life concept. The illustration shows the minimum premium necessary each year to keep the policy in force and then an alternate proposal shows how the total premium outlay can be reduced if premiums are level, using interest to cover a portion of the higher mortality charges in later years. I hope that no one falls into the trap of assuming favorable persistency on a select and ultimate term product simply because Universal Life fund mechanics are wrapped around it. I do not know of any product that goes quite that far, but the trend toward lower target premiums is leading us in that direction. On the positive side, by using minimum first year premiums and appropriate surrender charges, Universal Life can be designed to operate much like deposit term (even if mortality charges are select and ultimate).

About a year ago there was a resurgence in interest in decreasing term policies among actuaries and home office marketing departments. There has not been much follow-through in product introduction, I suspect because the resulting rate was not nearly as favorable as what had been hoped for before the actuary did the asset share studies. Since our customers, both agents and consumers, focus on the short-term cost of term insurance, the most attractive rate for decreasing term is produced by products with durations

of 10 to 15 years. This is especially the case now, since periods greater than 15 years no longer receive favorable tax treatment. Unfortunately, a straight-line decrease over 10 years produces a built-in lapse rate of 10%. I do not think that this type of product will be able to compete in the large size market.

Another product trying to make a comeback is Y.R.T. with attained age rate scales. However, because the premium necessary to support ultimate mortality rates at ages over 45 is uncompetitive by today's standards and is in fact much higher than that which the company can afford to charge for a more recently underwritten insured, some modifications have been made to the old-fashioned variety. The most common approach in avoiding this problem has to been to limit renewability to ten years or so. If a shorter period is used, it is difficult to recoup acquisition expenses, so products that are renewable for less than ten years must employ very low or level commissions. One company allows for re-entry after ten years with a very high renewal rate for those insureds who cannot supply new evidence. The policy expires after only a few more years, thus limiting some of the long-term anti-selection problems.

The last product design that I will mention is the one that my company is relying on. But first, I will summarize the events that led us to that decision.

Empire General Life, a brokerage subsidiary of Protective Corporation, was among the first to introduce select and ultimate term rates in 1979. Our term volume soared by several hundred percent, reaching $2 billion annually in 1980, when we started using non-smoker rate scales. In 1981 we changed over to a graded premium whole life design, both to enable a 5 year rate guarantee and for any possible tax benefit. On each of these products, our pricing assumption showed profits on direct business and larger profits on ceded business, so our retention was set at $100,000, rather than the $500,000 retention that applied to our other products. Due to developments throughout the industry last spring, we were forced to change reinsurers, and the new allowances were such that we could only break even on ceded business. At that time, in March of 1983, we increased our retention on the product to $500,000 and decided to replace it with a more reasonable design within six months.

We did introduce the new product in October, but we kept the select and ultimate product alive until year end because of the fresh start provision in Stark-Moore, as it relates to 818(c) 2 reserves.

Our new product is a ten year level premium term plan. Re-entry is allowed after ten years, with only one ten year renewal period permitted to those who do not re-enter. We felt that the re-entry privilege would be available to the policyholder anyway, by going to another company's product at the end of ten years. Following that logic, the choice is between no guaranteed renewal period at all and a re-entry provision with higher rates for those who are not healthy. The former choice was unacceptable to our marketing divisions, but we were able to convince them to allow us to terminate coverage after the second ten year period.

Another form of renewable term product is Term to 95 with the rate

increasing every ten years. Stark-Moore dashes any hope of favorable treatment under 818(c)2, but this design does enable a short-term guarantee of the current premium scale without the need to establish deficiencies or, I should say, minimum reserves. Some companies have combined level premiums with level commissions, while others assume that the level rate structure is sufficient to take care of the lapse problem. As with the Y.R.T. plans it is difficult to recoup acquisition expenses on other forms of renewable term if the term period is less than ten years.

I understand from some of my reinsurance friends that interest in the ten year level premium approach has increased substantially over the last couple of months. These plans compare very favorably with select and ultimate term on a ten year total premium basis and on an interest-adjusted cost basis using current market interest rates. I expect to see new innovations in this product during the summer, using graded premium whole life mechanics to extend the guarantee on the current rate scale. This type of product is the most likely candidate to be the focus of the next wave of intensive price competition.

A year ago in Chicago, the opinion seemed to be fairly evenly divided as to whether or not it was possible to price on a profitable basis select and ultimate term products with very steep slopes. Among those that thought there was a future for the product, most relied on the theory that the agent had a great deal of control over persistency and therefore commissions could be adjusted to produce acceptable lapse rates. Are companies that are still marketing a select and ultimate rate structure holding on to this belief, or are they simply waiting to see which one of the new products does well in the marketplace? And how about mortality anti-selection on products designed to encourage re-entry? How many healthy or even insurable policyholders are expected to pay a rate three times that which is available on a new policy? Maybe we will hear answers to those questions before the end of this meeting.

MICHAEL R. WINN: Term insurance is alive and well in the mid-80's. It will continue to be a vital viable product for the insurance industry. Term insurance will be with us for the remainder of this decade and well into the future. But, "Where's the beef?" The beef was an environment which saw direct companies lowering their term insurance premiums every three to six months. An environment that saw agents annually rewriting their insurance policyholder. An environment in which ten year re-entry term subsequently became five year re-entry term and then became one year re-entry term. It was an environment, in which reinsurers boasted ever increasing market shares as they fought each other bloody on the battlefield of price.

In 1984, I am glad to say that the term "burger" has shrunk considerably. Knowledgeable reinsurers are returning to saneness in pricing. There is recognition that marketshares have not paid salaries nor utility bills. Emerging experience patterns on term insurance are deviating adversely from pricing assumptions. Federal Income Tax considerations on graded premium whole life type products are severely eroded. And some direct companies are actually increasing their own term insurance charges. It is a very refreshing environment, and eventually "the beef" will come back into term insurance.

Next I will discuss what I see companies using for pricing assumptions from my vantage point as a reinsurance actuary. Usually the mortality assumption for term insurance products reflects non-smoker/smoker differentials. For non-smokers, companies are using an overall mortality assumption around 60% of the 1965/70 select and ultimate table. This is graded by issue age and duration. Most companies assume the differential between smoker and non-smoker mortality is completely eliminated by attained age 80 or 85. For smokers, companies are using mortality assumptions in the area of 100% to 120% of the 1965/70 select and ultimate table. In 1981, BMA began coding individual life cessions by smoking characteristics with three basic coding patterns; Preferred, Non-smoker and Smoker. To date, or at least at our last mortality study, which would have covered the anniversary year 1982, our combined non-smoker/smoker exposure amounts to slightly over a billion dollars of reinsurance. Bear in mind this is individual cessions and does not include any self-administered business. Our data bank will yield more meaningful statistics as our exposure in this growing line of business increases. Many companies are still pricing aggregate business. Companies that are active in this line of business are using a mortality assumption somewhere in the area of 80% to 85% of the 1965/70 select and ultimate mortality table. Some companies are using Preferred underwriting classifications in marketing their products. These companies use assumptions in the area of 45% to 50% of 1965/70 select and ultimate table. The Preferred category of plans, in addition to non-smoking, also have family history, exercise, build, blood pressure and other elements built into the rating process or into the underwriting process.

In discussing plans to control mortality experience, one must consider that we are in an era where everyone is price conscious, so it is up to the actuary in setting his assumptions progressively to coordinate with the underwriting department to make certain that the assumptions are, in fact, really met. There are at least two ways to control experience. One way is in the underwriting process. Another way to help control experience is through price.

Any company that is marketing a smoker/non-smoker product should at least get a nicotine screen test to insure that their non-smoker applications do not have a fairly substantial degree of smokers in their population. Some companies tested their underwriting criteria to determine what proportion of non-smoker applicants were actually smokers. One large term writer, in fact, found that 37% of their non-smoking applicants were smokers. There is no way to determine that unless you conduct a nicotine screen test during the normal urinalysis process.

Nicotine screen tests can still be utilized to prevent the company from having a large proportion of smokers in their portfolio. Another way to protect mortality experience is through the use of blood profiles that are available through the Home Office Reference Lab. Among other elements that are available from blood profiles is evidence (in our own studies) that the blood profile mechanism does provide knowledge on alcohol abuse, and we find that alcohol abuse is probably prevalent in as many as 50% of accidental deaths. Another sideline or another future benefit in the underwriting process from the blood profile will be a tumor marker which will indicate whether a tumor may be present in the body.

Another program which started at BMA about two years ago is Lifelong. It is a "wellness" type program. It gives credits for exercise. We make available to our employees counseling for stress or other emotional problems. We also make available different diets during the lunchtime program. Not only do we make this program available to BMA employees, we have also begun actively marketing our Lifelong program to group accounts. The reason I mention this program is that we feel this program will, by altering the lifestyles of our insureds, improve their long-term mortality.

Moving on to persistency experience, we publish our annual persistency experience typically toward the end of the year. Over the past three study periods, going back to 1979, 1980, and 1981, our overall termination rate in 1979 on coinsured annual renewable term business was 14%. That increased in 1980 to 18%. It increased further in 1981 to 24%. There is no real improvement in termination rates on this category of business evident in our portfolio by issue age or by duration. As a matter of fact, the termination rates typically start out low, in the area of 15%, and increase by duration rather than decrease. It also is evident that the larger cessions are the ones that experience the higher termination rate. In the larger cession categories the termination rates are roughly 28%.

Earlier this year I made a presentation on termination patterns by distribution system. I looked at a brokerage company (stock company), a small to medium size mutual company which sold on a PPGA system as well as a brokerage system, and a large mutual company which sold only on the general agency system. What I found was that in the case of the large mutual, on their standard cases, the termination rates were somewhat better than the average termination rates on standard cases. On sub-standard cases their termination rates were much higher than what I saw in the other two categories. Sticking with the situation of a large mutual, when you combine both their standard and substandard termination rates, it was about equivalent to the other two categories. There was no substantial difference between the termination rates by distribution system. In the early durations, the large mutual had considerably more conversions than the other two companies. In controlling persistency I would only have to echo some of the remarks made earlier; levelling commissions, declining cases that show a high lapse profile, perhaps going from the select and ultimate term variety to an attained age type plan. One new idea would be to institute a lapse penalty so that if an agent had a lapse in the first or second duration, perhaps he would lose more than the commission received earlier on the case.

ROGER HEATH: Mike Winn has given the insights of an actuary for a reinsurance company concerning the dreadful mortality and lapse experience of ART over the last two years.

Randy Lowery has given the insights of an actuary for a life company concerning current trends in product design to respond to the dreadful experience. The trends in product design also are responding to actions of reinsurance companies and the federal and state governments.

I am here to give my view of the outlook of term insurance in the future.

As many of you know, Jim Anderson, the President of my company keeps the

keys to our corporate crystal ball. He used it in the past to predict the coming of Universal Life and he used it more recently to predict a continuing significant market for term insurance. Jim has addressed market share, so my remarks address the possible form term products might take in the future, not the size of the market.

My remarks address general product types, not specifics.

My remarks point to unorthodox tools, not to typical actuarial magic.

I intend to discuss three major topics.

1. Possible links to other nontraditional life products which may influence the outlook of term insurance in the future;
2. Cost considerations which may influence the outlook of term insurance in the future; and
3. Events in other countries which may influence the outlook of term insurance in the future.

The first of my major topics concerns possible links of term insurance to other nontraditional life products.

In the last few years, distinctions between investment vehicles and life insurance policies, and the distinctions between permanent insurance and term insurance, have become blurred. Life insurance contracts have included interest sensitive features, extending even to direct links to equity products. Some Universal Life policies have been designed to operate well at extremely low premiums, if not totally masquerading as term products. These innovations have occurred not because the technical aspects thrilled us as actuaries --- they occurred to meet the changing needs of a market which had been static for years.

The realities that these "non traditional" products were developed to meet include the following:

1. The legislative and regulatory environment.

2. Competition in a broadening spectrum of providers of the products once marketed only by life insurance companies.

3. The perceived volatility of the economic climate.

4. Changing demographics and market demand.

5. Consumer "savvy" - including those consumers in the "unsophisticated" markets as well as those in the professional and business markets.

Knowledgeable consumers have and will continue to want <u>either</u>:

1. No investment risk (read "component") associated with their premium dollar; or

2. Attractive performance on the investment component of the premium

dollar as evidenced by high current interest rates, by promised market sensitivity, and/or by tax advantages to the consumer.

In a nutshell, the comparison between products currently labeled "non-traditional" and term products of the future is this:

> The nontraditional products have emerged to respond to changing needs; the term products of the future will have to do the same.
>
> Some of the tools that term products use to do so may be some of the same tools that nontraditional products use today.

New term products, like these non-traditional products of the present, must either:

1. Reflect realistic assumptions as to future experience --- or ---

2. Find a way to pass some degree of the risk, some of the variables, to the consumer.

Which brings me to the second of my major topics: cost considerations which may influence the outlook of term insurance.

These cost risks include at least the following:

1. Taxes --- because of recent changes there are few opportunities for artificial` adjustments such as 818(c) --- taxes on a more realistic measure of "gain" are the rule of the day --- but the tax environment could change again. Further, the tax environment must also be viewed to include policyholder taxation. Changes in the tax structure affecting the owner of life insurance must affect the way the products are designed.

2. Lapses - high variation in persistency should be expected with changes in product design and the economic environment.

3. Compensation --- trends may be to direct charges for the services of the agent, lower commissions, and/or level commission rates.

4. Expenses and inflation --- recent assumptions have included marginal expenses, allocation of expenses which stressed percent of premiums (favoring pricing for term products), and amortization of expenses over an assumed expanding portfolio. Companies may be less willing to make aggressive expense assumptions in the future.

5. Reinsurance costs --- few if any future products will be able to rely on reinsurance for a major portion of the profits.

6. Mortality costs --- will mortality trends continue to show improvement? Can we rely on these aggregate statistics in any economic environment? And what effect will new designs in term product have on mortality experience for those plans?

7. Product development costs and product "shelf life."

If products will be developed to cope with the changing economic environment, if products will be developed to meet the consumers expectation, if products will be developed to meet realistic cost expectations, how are we to know what to expect in these fields? And, if we know what to expect, how can we get an idea as to what products we actuaries might develop to answer these market needs?

Which brings me to the third of my three major topics: Events in other countries which may influence the outlook of term insurance in the U.S.

I think that one way to broaden our understanding as to the way insurance products can respond to changes in the world in which we live might be to look at the responses of the life insurance industry in countries which have similar if not identical social, political and economic structures to our own. What differences exist in the external factors which influence design of insurance products? What term products are popular in these areas? And how can we continue to look to these other countries for seeds of ideas?

To answer these questions, let's look at our neighbors to the North, Canada, and to another English-speaking nation which has been ripe with product innovation, the U.K.

The future of term insurance in any country is tied to many factors, some beyond the control of company actions. Examples include:

... Regulation of policy provisions;
... Regulation of policy reserve standards;
... Taxation of the policyholder and the company; and
... Changes in the economic health of the country.

The first country is Canada. As a commonwealth country, but with a significant French heritage, Canada's economic and political environment is different enough from that here in the U.S., to provide valuable lessons.

... Canada's regulation of policy provisions are less onerous;
... Canada's requirements for policy reserves less stringent and exacting; and
... Canada's income taxes to the policyholder are significantly less favorable;

This favorable environment, relative to policy provisions and reserves, is long standing in Canada --- but the unfavorable tax situation is a relatively recent change. The change, in effect, taxes interest on life products as ordinary income to the policyholder.

Some products have been developed in Canada with provisions which are unusual --- even illegal in the United States. The adverse tax change mentioned, as well as the crazy term market in the U.S., have influenced many of the new Canadian products. Typically, the products are level premium, level death benefit, non-renewable term, with periods from term for three years to term to age 100. Many have no cash surrender values; some have no nonforfeiture benefits.

You heard correctly: Level premium, level death benefit, term to 100, with no nonforfeiture benefits. (Can't you just hear Elizur Wright turn over in his grave).

Let's take an example and see how a company might develop competitive long term rates in Canada.

1. The policyholder might pay the underwriting fee;
2. The policyholder might pay the agent's acquisition fee (read "commission"); and
3. The policyholder might receive a contract with no nonforfeiture benefits.

With the above specifications, the level premium, level death benefit, term to 100 for a non-smoker, issue age 35, might be as low as $2.50 per $1,000. In addition, the policyowner would pay the policy fee and acquisition charges.

Insurance with no cash values has been considered in the U.S., but the current regulatory environment and general resistance to change combined to table these considerations. Many in the U.S. believe that the idea has merit. If the regulatory details could be worked out, these products could well have a significant impact in U.S. market in coming years.

The second country is the U.K. The U.K. economic and political environment has favored innovative, <u>permanent</u> products.

... U.K. regulation of policy provisions are less onerous;
... U.K. requirements for policy reserves are less stringent and exacting; and
... U.K. income taxes to policyholders <u>were</u> very favorable.

The U.K. actuary has complete responsibility for adequate policy reserves. There are no mandatory guarantees of principal as there are in the U.S.

The economic, regulatory, and tax environments have encouraged innovation in the U.K. That innovation has been directed toward investment products. For example, one of the most important plans was a ten year endowment. One important reason for this was the deductibility of premiums for federal taxes. Remember that individual tax rates in the U.K. are very high compared with the U.S.

Recently and suddenly, a key element changed: premiums are no longer deductible to the policyholder. It would not be surprising to witness a reduction in the sale of endowment policies. Given other factors in the U.K., it is highly likely that innovative term - type products will be developed in short order.

An actuary wishing to deal with a changing term market in the U.S. might be well served by paying close attention to the events in the U.K. and Canada.

Why? There are three basic reasons:

1. If the U.S. environment moves toward that of the U.K. before the recent change in policyholder taxation (recall the U.K.'s relaxed regulation of policy provisions relaxed, regulation of reserves, and favorable policyholder taxation), there may be little term product innovation. After all, why innovate term when you sell ten year endowments?

2. If the U.S. environment stays relatively static concerning policy provisions and taxes, the U.K. market may provide ideas for new products. After all, the U.K. term market may be behind that in the U.S. now, but the U.K.'s economy, the U.K.'s regulation, and the U.K.'s taxation, combined with the British penchant for the eccentric, may provide a fertile ground for ideas for the U.S. actuary.

3. If the U.S. environment moves toward that of Canada (also recall Canada's relaxed regulation of policy provisions, relaxed regulation of reserves, and onerous policyholder taxes), there may well be a move to term products which solve many of the current problems in the U.S.; products which currently are being sold in Canada.

In summary,

1. We have seen that term products of the future may have some similarities to present nontraditional products.

2. We have seen that term products of the future must respond to realistic estimates of their true cost, and

3. We have seen that circumstances in other countries may aid us in developing term products of the future.

MR. DOUGLAS DOLL: Roger mentioned the level premium/no cash value products in Canada. An associate of mine, Randy Mire, had an article in the March issue of Best's Review on term insurance, which discussed possible future trends in product design. The article mentioned low premium term insurance and said that at least one company has introduced this plan. The article also mentioned that the lack of commissions obviously would not appeal to many agents. Unfortunately, Randy was out of the office when Best's Review came out, so I got a chance to handle the calls from the agents who wanted to know which companies are selling the product, as they were interested in selling it. One agent in particular was offended when I told him it was a Canadian company, and he could not sell it.

Roger also mentioned the illegality of having Term to 100 in the U.S. with no cash values. Whole life with no cash values is an item that has been on the NAIC agenda for the past couple of years. It is an item that I think had some push behind it a year or so ago, but now it is sitting in limbo. In fact, it may even be cancelled. There was a proposed bill in Nebraska within the last year or two to allow whole life insurance with no cash values, but the agents killed it. We probably will not see no cash value whole life in the U.S. anytime soon.

MR. JAMES W. PILGRIM, Economerica Reinsurers Company: I have a question for Mike and a couple of observations relative to Randy's and Roger's comments. My question for Mike is concerning the nicotine screen. The last I heard was that there was a fairly high frequency of false positive results with the nicotine screen which made the reliability questionable. Have they improved the reliability of this test?

MR. MICHAEL WINN: At the home office reference lab we are constantly looking at ways to improve the results of the test. We provide a numerical range. I believe the range is from 0 to 10. A person with a 10 would be a three pack a day smoker. A person in the area of 4 to 5 could pick up smoke just from being in a room, so there is an element of judgment in the underwriting process. If you have an applicant who says he is a nonsmoker, and he shows up in the one or two range, you have a pretty safe feeling that this individual is in fact a nonsmoker. Have our techniques improved? Yes.

MR. JAMES PILGRIM: I have two other comments relative to Randy's and Roger's discussion. One is that we may see a trend more toward the fee base financial planning to which you referred. If that occurs, our distribution systems may change. We see companies who specialize in certain products that are using agency forces of other companies to distribute their products with the full knowledge of the other companies. Thus we might not have as much competition among the insurance companies to have the best product on the street. The competition would be for the different distribution forces in use. Randy made a reference to a non-commission deposit term type contract. If more companies switch to a fee based financial planning concept, the buyer will be paying an up front fee and relying on the agent, broker, or consultant to get him the best product. We may find changes in products, and we may find an improvement in persistency because the buyer may have the tendency to go back to the same consultant. Granted there is a possibility that that consultant would use different companies. We may find an improvement in the persistency of term insurance when it is distributed in this manner.

MR. LARRY STOKES, Johnson & Higgins: That brings up an interesting point: because the fee paid to a financial planner is tax deductible, versus a commission which cannot be deducted as it is never isolated, there is potential to pay higher fees and have a more competitive profitable product.

MR. P. RANDALL LOWERY: A couple of comments. First on the nicotine screen and the unreliability of the results. Even if the results are unreliable, the screen still has some benefit. If the potential insureds are aware that there will be a nicotine screen, they are much more hesitant to misstate their smoking habits. Even if you were not going to look at the screen to use as a basis for classifying someone as a smoker, it might still be of value in eliminating the number of false statements you would get.

Fee based products may improve persistency. The reason for this stems from the way the fee is collected. The agent shows the prospect long term savings even though he is paying a fee to purchase the insurance. Therefore, though the first year cost may be higher, the plan is superior to plans that pay commissions, so the insured will save money in the long run. Thus the plan is being sold in a way that could be conducive to good

persistency. As far as tax deductibility, there are still some questions as to whether or not the fee paid for the purchase of term insurance would be tax deductible. The fee has to be shown to be investment related, and there is some question as to whether or not the fee to purchase term insurance could be deducted as an investment expense.

MR. MELVILLE J. YOUNG, General Reassurance: A number of companies have found success using inspection reports, and I did not hear that mentioned earlier today. Several companies have cited a good deal of success for the same reason Randy noted. If the agents know that someone is going to be watching, perhaps there would be fewer untruths. Another thing people have talked about in the past is asking more than one smoker question on an application. It has been shown statistically that people tend to lie less often if they are forced to lie twice.

Just a comment about last year's Chicago conference. Statistics may not have been published prior to Chicago, but I think many of us, even those of us who were selling and reinsuring select type products, knew of the problems prior to the Chicago conference. The purpose of the Chicago conference was to give people the courage to act on their convictions. To show people that there were companies that were doing something. Since the Chicago conference quite a number of companies have stopped selling term or have adjusted the types of products they are offering. I am curious if there are any big term writers in the room who could report to us what the results of their persistency have been.

MR. DOUGLAS DOLL: Just some random thoughts. One, it is my personal opinion that some companies ought to be taking a little more advantage of the tax free build up available in life insurance, and perhaps once the tax laws for life insurance companies settle the definition of life insurance and so forth, maybe we will start to see some product innovation. One example is term insurance with extra premiums paid up front, with the interest on that excess premium being used to pay for the future term premium. In effect, what you are doing is paying your term premiums with tax free investment dollars.

Also in the area of taxation; the various penalties on annuity partial withdrawals in certain situations reduced the attractiveness of buying term and annuity as opposed to buying a whole life policy. I know of at least one company that was selling term and annuity instead of Universal Life. As a result of the tax penalities on annuities, this company decided to switch over to Universal Life.

Regarding smoker/nonsmoker rates, I think we have seen a trend toward larger differentials in smoker/nonsmoker rates. One large term writer recently raised the premium on their graded premium whole life product. For nonsmokers they just increased the noncommissionable policy fee. For smokers, in addition, they raised the basic per thousand rates. We are still seeing an increase in smoker/ nonsmoker rates, but I have seen very few rates yet that reflect what my personal opinion is as to the full differential. Some of this is due to the people who lied to get the nonsmoker rates, and we cannot express the full smoker/nonsmoker mortality rate because we do not have a pure smoker/ nonsmoker portfolio. However, I think a lot of companies probably are using pure nonsmoker assumptions on

their nonsmoker rates and are charging higher mortality on the smoker rates. Last year the Society came up with smoker/nonsmoker versions of the 1980 CSO. You may or may not agree with the assumptions used to come up with those tables. I have some doubts about the assumptions at the very young ages. At the higher ages I tend to agree with the assumptions for the ratio of smoker to nonsmoker mortality. I have noticed that some reinsurance quotes seem to agree with those assumptions also.

My final comment is about conversion privileges. Back when we had aggregate ART, the conversion privilege was a big deal. When the select and ultimate policies came out, you still saw conversion privileges. I think perhaps when companies price term products, they may not even include any provision for conversion costs. They may just say the rate is 1% or 2%, and it is included in the lapse assumptions. Does anybody here still think that conversion rights are a salable item in term insurance? Should they be in term insurance? What is the cost that should be included in term insurance for this benefit?

Somebody at the Chicago meeting was talking about his theory of select and ultimate mortality. I think the figure he gave was that in any group of 1,000 people that were select, two of them would become impaired in the following year. So if you were to assume those two people were going to convert, that implies $2 per thousand of conversion cost. I do not think it is that great, my math is probably wrong, but there may be a significant cost there.

MR. BOB WHITNEY, A. L. Williams: We are a large writer term insurance, probably not the type Mel Young had in mind when he asked for further experience, but I thought I had to stand up because it seems to me that no discussion of term insurance would be complete without some mention of the type of product we are selling. So I just wanted to give you the highlights of our type of operation.

The A. L. Williams sales organization is going to write somewhere between 35 billion and 40 billion face amount in 1984. Forty-five percent of our applications are for new insurance, fifty-five percent are for replacement. Of those 55% we typically replace a $25,000 whole life policy with $125,000 term policy. With regard to our product, approximately 75% of our sales are a term policy and a term rider. Both are Term to age 85 with premium changes every 15 years. The base policy has a so called "deposit" in that the premium is considerably higher in the first year to provide margin for sales compensation. There is no pure endowment with this type of product. The term rider has a step up in premium in the second year. The base policy provides the margin for commissions. We do not allow the base policy to be sold above certain amounts which in terms of premium, work out to about $500 to $900 of annual premium according to age. If the size of the policy exceeds the limits that we have set, the field agent must sell this term rider that I mentioned. We call it a no load rider because there is absolutely no commission in the first year, and this accounts for our tremendous face amount sale. Our field has responded. In some ways, it surprised me how well they have responded to a rider that does not pay commission.

Our mortality experience is similar to what Mike Winn mentioned, 80% to 85%

of 1965-70 select and ultimate table on an aggregate basis. We do find that we have an incidence risk in year one that exceeds our original pricing assumptions. In year one we are getting about 120%. It varies somewhat by age. But 120% of the 1965-70 table, we understand, is not unique with us. We just happen to have enough volume to be able to measure fairly well. We are pleased that the incidence risk does seem to disappear going into the second policy year. We do have a persistency bonus that has both a reward and a penalty feature. One of the speakers talked about the concept of penalty, and ours is working. We define a persistency rate as the amount of policies that pay at least a 13 month premium divided by the number of applications submitted. We work off a submitted rather than a paid for basis because we pay commission with the submission of the application, and we will not reward as well as penalize for lapsation. We have a company standard and for agents that exceed the standard we will add 2 1/2% to the second year commission for every 1% by which they exceed the standard. Likewise for every 1% that they fall below our standard, 2 1/2% will be subtracted from this second year commission rate, and that does mean a negative second year commission in some instances. Our first year persistency is in the order of 25%. Our second year persistency is in the range of 12%, and we do see some signs that recent issues are going to have a better second year persistency. Our expense experience is worth commenting on. Our 1980 issues had a ratio to actual pricing assumptions of 150%, in 1981 the rates were 120%, for 1982 issues 100%. and for 1983 issues 80%.

MR. MICHAEL WINN: Many including the panel here are active in the consulting community. We have been talking about term insurance from different facets here this morning. I would like to get some feedback from the group, at least from those who are active as consultants, about what you see companies doing in the area of term insurance. In the past few days I got the impression that the reinsurer was the one allowing this abuse in term insurance to continue. I sense that that is no longer the case in many reinsurance circles. What is going on in the consulting community?

MR. RANDALL MIRE, Tillinghast, Nelson and Warren: I am still extremely concerned about term insurance and about select and ultimate term in particular. We have seen a number of direct writers who are moving in the right direction but not far enough. I feel very strongly that select and ultimate term with a high front end commission is inherently unsound and that there really are no steps you can take with that product to eliminate the adverse persistency and mortality. The basic product must be changed away from select and ultimate and away from high front end commissions. There are some companies that are moving in that direction with other products that have been talked about; like deposit term, aggregate rates, and levelling of commission, but not nearly far enough. I am also still concerned about the role of the reinsurers. The reinsurers have pulled back, but I do not believe that they will necessarily stay in that position. If you look at the direct business written by the reinsurers, it has grown by something like 400% in the last few years, and almost all of that increase is due to coinsurance of select and ultimate term. Most of the reinsurers are patting themselves on the back because they are not going after marketshare, rather they are going to stay at their current level in terms of production. If you look at the fact that maybe 80% of their production is due to coinsurance of ART, I do not know where they think they are going to get the business to stay at their current level. It is sort of

like inflation rates have risen to 25%, and everybody is happy that they are going to keep them at 25% instead of dropping back to a more rational level. I am afraid that a number of reinsurers are going to find a lot of internal pressure to at least keep new business where it has been historically, which is going to lead them back perhaps to where they were before, subsidizing select and ultimate term. So I do see term insurance as being a very large part of the marketplace in the future at least partially because its going to be priced on a breakeven basis, and I do not think we have gone nearly far enough to correct the product.

MR. MELVILLE YOUNG: I want to respond a little bit to what Randy just said. I wrote a paper about 18 months ago in which I said that it was amazing to me that there were still companies chasing the select term market, and there were still reinsurers chasing that market, and 18 months later with all the revelations we have just been talking about there are still companies chasing that market. Some reinsurers have expectations of making a profit in the market, and I find that amazing also. The suggestion I would make following Randy's marketshare observations is one of the things that I have suggested that we do at General Re, I suggested that we take a look at our recent new business and reduce those recent years' new business writings by a percentage to reflect business that was not real, but just temporary term business. That was where we were replacing our own business every year since we have many term clients. Perhaps a better way of looking at our production is to take 40% of the number rather than 100% of the number. We would base new business expectations on that basis. When we have discussed changing what client companies were doing in this market, we urged them to look at this because we were guessing they would have a marked reduction in sales, and it was something they should be aware of. If you have been heavily into a select term product market and are moving away from that, you have an inflated sale. Inflated for a couple of reasons, not only the one I just mentioned but also because people were overbuying, which leads into the third point I wanted to make which is that people were buying based on premium, not based on face amount need, and therefore, there was a lot of over insurance being purchased and we reinsurers as a community all seemed to have experienced a very interesting phenomenon disturbing but interesting. Part of our bad mortality experience in the last two or three years has resulted from a much higher than expected violent death mortality. We have taken a look at this. Even though our base is heavily slanted towards new issues (so that one would expect something more than the 10% of population mortality from violent deaths), weighting by exposure should make this number much more than 25%. We are seeing something around 40% currently. We have tried to meet this problem by intensifying our financial underwriting, but again it is another problem of the product and another reason why we all seem to agree it should die a quick death. How many companies are taking term products off the streets?

MR. MICHAEL WINN: We have not seen a new select term product to quote on in something in excess of six months.

MR. RANDALL LOWERY: As a follow-up to that I feel like the companies that are still marketing select and ultimate term are doing so because of their expectations as to mortality. For all the pricing we did on our term product when we were coming to the decision to take it off the market, it was possible by lowering the overhead or fixed expenses enough and coming

out with a reasonable level commission scale for the product to withstand 25% and 30% lapse rate forever. In this whole problem, our anti-selection is just theory because there has never been an instance before that I know of where you have had jumbo million dollar face amounts that were lapsing off at the rate of 25% and 30% every year over a long period of time, so nobody knows for sure exactly what the mortality rates are going to be 10 or 15 years from now. There were a couple of theoretical presentations made in Chicago that showed clearly that the mortality rates 10 to 20 years out depended heavily on the degree of sophistication you assumed among the buyer and the agent. You could get anywhere from no anti-selection, that is, lapse rates are just high, to perfect anti-selection that is the only persons lapsing their policies are the ones that are insurable and could get a new policy. Everybody agreed that under the perfect anti-selection scenario, mortality rates are unbelievably high, and it is impossible to price any kind of product. You cannot make the premium high enough to cover that rate, so my feeling is that the companies that acted quickly to withdraw products from the market are the ones that are assuming high levels of sophistication in the marketplace resulting in anti-selection. They are worried about what is going to happen 15 years from now, whereas the companies that have not acted are designing products that can withstand high lapses from an experience standpoint and assume a lesser degree of sophistication and anti-selection.

On one of the points you brought out, Doug, on the difference in smoker and nonsmoker mortality rates being used in the industry, is that there is quite a division of opinion among the reinsurers as to how to divide the mortality rates between smokers and nonsmokers. For the last year or so we have been asking the reinsurers to quote allowances on the smoker and nonsmoker classes separately and a divergence of opinion is clear. Formerly we were getting, just as an example, a renewal allowance of 12% among 4 or 5 reinsurers. When we go back and ask for a quote on the smoker and nonsmoker classes separately, reinsurer A says the allowance is 20% on nonsmoker and 3% on smoker. Reinsurer B may say the opposite, so I am wondering if the reinsurers have thought about being selected against in that manner and that there is a divergence of opinion. If you are aggressive on your smoker quotes you are going to get more smoker business, and the reverse is also true. Both sides cannot be right, however.

MR. JOHN CATON, Picking up on the nonsmoker/smoker idea, there are some things that concern me and one of them is that we are seeing more companies jumping on the 1980 CSO task force report of nonsmoker/smoker mortality. I think it is a dangerous thing to do, because that study was done for valuation purposes and not for pricing. I agree with Doug that the mortality ratios in that report may be a little off, particularly at the young ages, but it is amazing how sensitive the nonsmoker/smoker split can be to the proportion of people that smoke. That report is by design looking at the smoking percentages in the 70's which is the time of development of the 1980 CSO underlying data. As I remember, the proportion of people that smoke at the central ages is something like 45%. The Surgeon General's reports in particular show a definite trend toward less smoking. If you pick say a 2/3 to 1/3 split, which seems to be a convenient number that a lot of people use, it makes your smoking mortality quite high and has an effect on the nonsmoker mortality to lower it a little bit. I think some of the reaons that smoker rates are so artificially low is that some companies might be using this 1980 CSO data.