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CURRENT INDIVIDUAL TERM PRODUCT TRENDS

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- Mortality and persistency
  - Recent experience
  - Programs to control experience
- Current trends in product design
  - "Traditional" term products
  - Recent innovations
- Future outlook for term insurance
  - Cost considerations
  - Interaction with other non-traditional products

This is Session 6, the Open Forum on Current Individual Term Product Trends. My name is Ed Jarrett, from Tillinghast, Nelson & Warren and I would like to introduce my fellow panelists; Bill Weller from North American Company for Life and Health and Gary Dahlman from Milliman & Robertson out of Seattle.

This session will cover three areas. First of all, Bill Weller will cover Mortality and Persistency, then I will cover the Current Trends in Product Design and lastly, Gary Dahlman will cover the Future Outlook for Term Insurance.

MR. WILLIAM C. WELLER: I would like to quote from Lynn Peabody since what he said last year still holds true today:

> "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 design, and finally what has actually happened."

We will also look at some "modified expecteds" and why the modifications may be reasonable. I will be reviewing mortality and persistency from three points-of-view:

1. Individually, i.e., looking at each component as a direct writer.
2. From the reinsurer's point-of-view.

3. Combined point-of-view - looking at how the total combination effects bottom line - being an optimistic person, I'll look at break-even year (the alternative may be loss recognition).

EXPECTED

Mortality -- We, as a group, have probably made more mistakes here than anywhere. I'm reminded of the Aesop fable of the dog and his bone. When he saw a reflection of himself, he saw another bone (more market share). As you know, he dropped the bone he was carrying to reach for the other one and ended up with nothing. The life insurance industry had a bone (the mortality charge) all to itself but we've given most of it away, going for a bigger looking bone. How have we lost it?

Non-smoker discounts that don't also adjust upwards the charge for Smokers (somehow they are still aggregate).

Select Term (there is no longer an ultimate) with free re-entry (somehow those who don't re-enter will not really be anti-select).

Face amount is based on ability to pay first year premium (we no longer believe that economic status has a major effect on mortality levels).

What I'm saying is that our expected was based on past reality unadjusted for how _we_ were changing reality. So we used some percentage of 65-70 S&U and felt conservative when we didn't build any future mortality improvements in.

Persistency -- Expected lapse rates of 20-30% first year decreasing over 3 - 5 years to 10-15% have been shown to be totally inappropriate. Lapse rates on Select Term must recognize variations by size, age of insured, agent type, premium mode, percent of premium increases, re-entry provision and its administration and your competition.

Reinsurance -- The expectation that you can always get or replace your reinsurance coverage and improve the arrangement to cover your costs should be rapidly fading. If you don't want a market dislocation, you should be developing an ongoing relationship with your reinsurer on how to improve your results.

Bottom Line -- An expected break-even year of 7+ would probably have been used by many companies as recently as two years ago. In most cases, this meant that they were expecting significant profits from "post re-entry" years.

FEARS/ACTUALITY

I can now speed up our review by covering what we _feared_ and what _actually happened_ at the same time:

Mortality -- The potential effect of anti-selection on mortality is still in the future. It has, however, gone from a theoretical possibility to an accepted theory.

The effects of smoker versus non-smoker mortality on a broad industry basis is showing results comparable to the State Mutual/Phoenix Mutual experience. Smoker mortality of one reinsurer averaged 2 times the non-smoker results. Several larger term writers are modifying their smoker rates or the products available to smokers.

I am also told that mortality on older blocks of aggregate smoker and non-smoker business has deteriorated by a "significant" amount.

Higher mortality has also resulted from specific causes (particularly accidents and violent deaths) and/or the effects of easier underwriting. Underwriting costs were limited because of the lower premiums and desire to be more aggressive and "service oriented", and the result has been felt quickly.

Persistency -- We have more experience here than we want. The results can be classified as uniformly bad. The first slide shows the persistency of our GPWL policies. We have been reviewing quarter-of-issue results at regular three month periods. The results show some interesting things:

First, when the annual business is eliminated, there does not appear to be any reaction to premium increases.

Second, once annuals have a chance to lapse, their persistency is uniformly worse than the other modes.

Finally, the variation in persistency by amount of insurance and age are much greater for the annual mode than other modes.

The next few slides look at our persistency results for years 1978 through 1983. They use valuation files and, therefore, develop a total termination rate for each exposure cell (plan/duration/valuation year). I have distributed these termination rates based on policy count into various ranges. No attempt has yet been made to recognize weights by count - each cell counts as a unit in the distribution by termination rate.

In slide two we see the relative acceptability of the overall results by product group. Weights were given to each termination rate grouping from 0 to 6. Since the groupings do not vary by duration and valuation files cannot be used for early years, only years 4 and later are shown. We expect an upward slope to these graphs but persistency values under 2 are considered unacceptable.

We can also get some perspective on the effect of most recent experience by looking at just 1982 and 1983 as shown on slide 3. Note that the biggest area of change is in renewable term and that the unacceptable area is extended. Another way of looking at this is to review the percentage of exposure groups with unacceptable termination rates.

Slide 4 shows these percentages for 1978 - 1983 experience. While the permanent is not terrific even through the 10th year, the results for renewable term are atrocious through the 10th year and still bad even beyond.

Slide 5 shows the effect of the most recent years. Obviously renewable term persistency rates under 20% are not realistic.

Reinsurance -- As feared by many direct writers, the free ride provided by reinsurers with their high front-end allowances is over. Contracts are being revised to provide lower allowances. Specific rules on replacement business and stricter underwriting on facultative are now common.

Bottom Line - Both reinsurers and direct writers have had sharply lower earnings as the original assumptions and the deferred acquisition costs created have had to be adjusted for not only the adverse experience, but also the reduced flow of future premiums.

Finally let's get to the "modified expecteds" or methods to effect the experience in the future. In general, I would suggest that to do this we must get back to basics:

Mortality -- Include the cost of all benefits in the pricing and recognize that giving better rates to non-smokers means that the balance of the groups must experience worse mortality than the group as a whole. If you have been recommending this to deaf ears - i.e. "must have competitive premiums for smokers" - help is on the way from direct writers who are not waiting for everyone else and from reinsurers who are no longer using average coinsurance allowances.

Re-entry provisions can keep business in force that would otherwise go to other companies but the cost can be considerable if your rates for those not re-entering do not reflect the extra mortality. One of the big problems here is that the higher you make the post re-entry premiums the more you force re-entry and the heavier the anti-selection. Several companies have or are developing products which are renewable with evidence only. This moves the low cost term closer to the approach for P&C insurance - i.e. level commissions, and both company and insured can terminate.

Tightened underwriting may make a lot of sense, the reinsurers are going to do it on your facultative issues so the agents will have to get used to it. Make sure your pricing agrees with your markets - the need for more effective use of financial underwriting and the recognition that the potential cost of foregoing underwriting information isn't just the extra claims during the contestable period.

Persistency -- Many companies, including North American, are recognizing the need to underwrite for the persistency risk. This involves past experience (replacements) as well as the ability to pay the renewal premiums and the real need for the applied level of insurance. Our persistency underwriting program was put into effect in May, 1983 and provides a level commission alternative to the agent for any application which doesn't meet our persistency underwriting requirements. We have been satisfied with the results. During the second half of 1983 our production dropped, but the reduction was less than the amount predicted and we placed almost 600 GPWL policies on the level commission scale.

Other things that can improve persistency are:

1. Review of persistency by agency.

2. Reducing the slope of the premium scale - level premiums are best, an aggregate select scale for several years is the next best.

3. If you have a rapidly increasing premium scale, consider offering a better deal on non-annual premium modes which reduce the one-time effect of the premium increase.

4. Develop conversion programs to allow exchange of high lapse products to low lapse products.

Reinsurance -- I will leave it to some of the actuaries from the reinsurers to share how they will be adjusting what they offer and what that means to your product. I would again suggest that you work with your reinsurer - use the information they can provide in the development of your products.

Bottom Line -- Here I believe that the use of modified experience will demand the expectation of a much earlier break-even year. To do this, the real premium income will have to be increased and the front-end costs will have to be reduced through levelized commission scales. Some companies are also using marginal cost approaches in pricing to get lower premiums. I have also heard that some companies are willing to write term at no profit to develop their relationships with new agents.

We have been traveling through an extraordinary period in the term marketplace. Rates have gone down to unbelievably low levels only to be reduced further. These constantly reducing rates have provided the agents with a valid basis for continued rewriting of the same insureds. Our steeply sloped premium scales have added to the problem. But things are improving. Sufficient experience is becoming available so that premium levels should be changing. Reinsurance allowances are forcing commission levels down. Underwriting procedures have demonstrated their effectiveness in reducing your exposure to extra claims and high lapse potential cases. It may even be possible again to get profit relative to the significant risks we are taking.

MR. EDWARD C. JARRETT: First of all, let's look at the trend in term rates since 1971 for a major term writer.

In 1971, this particular company didn't have an ART product on the market. They had a 5 C&R product with rates at age 35 of $4.36 per thousand. In 1975, they came out with their first ART product. This product had premiums of $2.51 at age 35. By 1980 they had reduced those premiums on that same product to $2.03. In 1981 they came out with their first select and ultimate term product. This product had separate premiums for both smokers and non smokers and the first year rate at age 35 was $1.48 per thousand. In 1982, the company came out with a graded premium whole life product. And again, the rates were split between preferred and, so called, nonpreferred or standard. The first year preferred rate was $.95 per thousand. Since 1982, and during 1983, there has been literally dozens of companies with rates at age 35 of under $.90 per thousand, and some, even down below $.70. So that $.95 is not overly competitive.

Two years ago there was a major flurry of pricing activity in the term market. We felt that over 75% of the new products that were coming out were of the select and ultimate variety. That included select and ultimate term, re-entry term and graded premium whole life. The rest of the products consisted of some ART's, a few deposit terms and a decreasing term product here and there. No one really wanted a term war, however, with so many products hitting the street and with replacement in the best interest of both the policyholder and the agent, a term war was inevitable.

In the summer of 1982 the horror stories began to come in. Reinsurers were experiencing lapse rates in excess of 35% and even higher at the large amounts. Overall lapse rates in excess of 35% and even higher at the large amounts. Some reinsurers declined to quote on the new select and ultimate products, while others were actually pulling out of the select and ultimate market. Not only was persistency deteriorating but mortality was climbing to new levels as well with violent deaths, cancer deaths leading the way. Looking back, I think we have all learned a lesson, especially we actuaries, in terms of our perception of the intelligence of both the consumer and the agent. One insurance executive put it well when he said, "Any product which depends on either the loyalty of or the lack of sophistication on the part of the policyholder or the agent for its profitability cannot long endure."

If we consider the nature of the select and ultimate product with its steeply increasing premium scale and the high front end commissions, we come to the following conclusion: a low premium coupled with a high commission equals high lapse. It's very simple. You have an agent getting a high front end compensation. You have a policyholder who is looking at a second year premium increase any where from 20% to 50% or more. What are we implicitly doing? We are telling the agent to tell the policyholder to revert. And if the agent doesn't do it the policyholder will come back to the agent especially at the larger face amounts. That's precisely what we saw happening. It is in the best interests of both the policyholder and the agent to re-write that policy. But we, as pricing actuaries, maybe didn't look that far in advance. I firmly believe that the inherent design of the select and ultimate product with its steeply increasing premiums and high front end commission is faulty and that each policy should be stamped "Issue with Care."

Where are we now? Basically, the most obvious result is the pricing activity in the long-term select and ultimate market has been decreased significantly. What we're seeing is companies looking at ideas to improve persistency. If I had to characterize what companies are doing and put it into a single word, I would use the word "experimenting". Companies are experimenting with ideas in an effort to wean their agents away from unsound, unprofitable products to products that are perceived to be more sound and, at least, profitable. Companies are addressing the challenges in the term market in a variety of ways. Again, they're experimenting. Companies are not sure what's going to happen, but they are trying new things to improve persistency and, hopefully, profitability. Many companies are dusting off and re-examining their attained age ART products. This product can be moderately competitive with the select and ultimate product at the low ages. However, at the higher ages, it's fairly expensive, due to the fact that the premium must cover ultimate mortality. There are two ways to overcome this problem. The first way is to have separate products -- one for the low ages and one for the high ages. The second way is to cut off that long term mortality tail. That is, instead of having it guaranteed to age 75 or 100, you have ART for five years or ART for ten years. We've even seen ART for three or four years. These products, typically, are convertible for either the entire period or for a shorter period. For example, a ten year ART plan will be convertible for the entire term or in an effort to cut-off the last chance conversion, convertible for only seven years. These types of products can be reasonably competitive with the select and ultimate versions due to the fact that they no longer have to cover ultimate mortality at the higher ages. However, the short term leaves little time to cover expenses and make a profit. In my opinion, we also were dealing with similar constraints with re-entry products, in that companies should have been pricing to show a profit prior to the re-entry period.

From the agents point of view the short term nature of these products leaves much to be desired. Two companies who came out with five year ART plans last year were forced, by agency pressure, to add an option at the end of the five years to allow the insured to convert to their then existing ART-100 product.

We're also seeing a resurgence in five and ten year C&R products. These again can be competitive with an ART plan on a five or ten year average, but can't compete with a select and ultimate product on the going in rate. The level premiums for five or ten years helps solve that lapse rate problem. What we expect is some sawtooth pattern in the lapses being relatively high in the first year and then grading down and then jumping up again on renewal. The magnitude of the premium increase on renewal will have a direct effect on the lapse rate at the end of the term period. The problems with 5 C&R products are similar to ART. At the higher attained ages, the premiums must cover the ultimate mortality. To overcome this some companies are limiting the times a policy can be renewed. For example, a ten year plan may be renewable just once. While a five year plan, will be renewable just two or three times.

One product of this type that deserves some special interest is a term to 95 that came out last year by one company. This product was level term to 95 with ten year step-rated premiums, where the premiums were guaranteed for five years and non-guaranteed thereafter. So from a marketing standpoint, the premiums are guaranteed level for five years, anticipated level for ten years. Another unique feature of this product was the fact that it was not banded. A single premium scale for all sizes. However, the agent compensation was banded. At the low face amounts, below $250,000, they had a normal heaped commission pattern. At the higher face amounts, above $1 million, they had level commissions over the first five policy years.

I have on my list deposit term, which may or may not really be a term product. Deposit term is characterized by a high first year premium. The first year premium is broken down into a term component and an "additional premium" component. The additional premium is to encourage persistency. Generally, the additional premium doubles or triples in 10 or 15 years in the form of a cash value giving an implicit rate of interest. Deposit term has received a bad reputation, because it was the choice of replacement artists. However, there was one major term writer that came out with a plan last year. Their product is very similar to their ART in that it had competitive ART rates in the renewal years. To date, the product has not been well received by its marketing force. For the big hitters, at the large amounts the deposit becomes awesome.

I'd like you to consider the design of the deposit term. We've all heard about the matching of assets and liabilities. However, a deposit term type premium structure better matches the premiums versus the costs. I do not think that everyone's going to be selling deposit term, but down the road, as long as we're selling cheap term, somehow we have got to pass on some of these costs to the policyholder or the applicant. For example, an up front fee to cover the underwriting and issue costs.

Another idea companies are using is a "single premium" type of approach. This isn't your classical single premium where you have cash values. In most cases it is just a prepayment of premiums. What companies will do is give the policyholder a chance to prepay premiums for two, three or four years at a discount. For example, pay 80% of the premiums if paid in advance. This encourages the policyholder to persist, at least until the funds run out. After the fund runs out, the lapse rates will be very high.

Now let's consider select and ultimate term products. They are still a factor in the market and, in my opinion, they will always be a factor. There will always be a few companies out there willing to be in that market. However, the real question is does your company or your clients want to be in that market? More importantly, are they capable of being in that market? Do they have good enough underwriting? Do they have reinsurers who understand what they are doing and vice versa? Or are they just taking a short sighted approach and farming out their select and ultimate business to whatever reinsurers will pay the highest allowances and opening themselves up to the possibility that six months down the road the reinsurer pulls back the allowances and the company has to withdraw the product. I think it's on our shoulders, as pricing actuaries, to inform our management or the management of our clients as to what options are available and what the implications are of their choices.

In terms of product design, how can a company be in the select and ultimate market? First of all, they will try to cut off that long term tail. Instead of policies being renewable to age 100 or renewable to age 75, they're making it renewable for just 10 years or 20 years at the longest. Secondly, we are seeing companies cutting down slope of the premium scale. Instead of the premiums going up by 20, 30, or 40% every year, they're going up by something like 10% to 15%. Thirdly, we are seeing companies levelizing the commissions, not necessarily level, but leveler.

Over the long haul, many companies will have to drop out of the select and ultimate market. There will be a small group of life insurance companies that become experts in this market. They will cut their costs, becoming very efficient in underwriting, selection and issue and price their product accordingly. Those companies that cannot follow suit will not make money in this market.

What are some other options for insurance companies? Basically they can take their current product and increase premiums, change the pattern of commissions or just withdraw the product all together. As of now, I know of 12 companies who have pulled their select and ultimate products off the market (no more new sales). Another 11 companies have revised their products.

In terms of product design, I would like to summarize by reiterating what Bill said earlier and that is "getting back to basics." It is our job as pricing actuaries to inform our clients and our companies what we think is going to happen in terms of mortality and persistency. Both are tied together - high lapse rates imply higher mortality. If your company isn't prepared to be a force in the select and ultimate market by cutting back costs and becoming efficient then, in my opinion, your company should focus on something else.

MR. GARY E. DAHLMAN: For the purposes of this discussion:

1. The use of phrase "ART type product" includes traditional attained age ART, Select and Ultimate ART, modified premium whole life plans designed to appear like ART for the first 10 or so years, and other similar products;

2. Comments are from the perspective of a direct writer and ignore any special reinsurance deals; and

3. Results discussed are pre tax, unless otherwise noted.

Before talking about cost considerations it might be helpful to briefly review statutory and GAAP accounting for term insurance products. Under statutory accounting term insurance, in absence of special reinsurance deals, usually shows a first year loss. This loss is often referred to as the investment in new business, although, for example, the operating loss does not include any increase in agent debit balances that might be associated with selling the business. If a term product is properly priced and actual experience conforms reasonably well to the pricing assumptions, statutory profits will be realized in renewal years in sufficient amounts to repay initial investment and allow the company to earn a satisfactory profit margin.

Under GAAP accounting there is typically a much smaller first year loss, or even a first year gain. Actual GAAP results vary considerably by company and depend on each company's attitude toward the capitalization of acquisition expenses. On the other hand, expected renewal profits are less under GAAP than under statutory, primarily due to the necessity of amortizing acquisition expenses capitalized in the year of issue.

Now let's address the section of the program entitled "cost considerations". I will first discuss the impact term insurance business already on the books will have on future statutory and GAAP financial statements. From what we've been hearing about emerging experience on term insurance products it appears that most companies have been experiencing higher than expected lapses (much higher in some cases), and that higher than expected mortality is likely in the future since the healthier lives have tended to lapse while the unhealthy lives have tended to maintain their policies in force. The degree to which this process occurs will obviously vary considerably from company to company.

Under statutory accounting the level of renewal profits will be reduced by higher than expected lapses; that is, less business will remain in force on which the company <u>might</u> earn a profit. Reduced renewal profits mean that the original expected profit margins will not be achieved, and if renewal profits are too low, the company's investment in the business in force will never be recovered.

And if the problems created by higher than expected lapses are not enough, the situation will be even worse in many companies as a result of the mortality anti-selection referred to earlier. The additional deaths resulting from mortality anti-selection will further reduce renewal statutory profits on term insurance. In some cases these "profits" may even become negative, and create a problem for the valuation actuary who must express an opinion that his company's or client's reserves are "good and sufficient". Since the reserve adequacy test is in the aggregate for the entire company, I suspect that in most cases, companies will have enough redundancy in their statutory reserves for business other than term insurance to more than offset any problems on the term side. However, there may be a few companies for whom term insurance is such a large portion of their total block of business that the valuation actuary will be confronted with a serious problem. This may lead to a qualified opinion, or other some sort of remedial action (reinsurance, capital infusion to allow reserves to be increased, etc.), if a qualified opinion is not acceptable.

Under GAAP accounting the situation is much different. Remember that acquisition costs have been capitalized which must be recovered from renewal

premiums. As the term business goes off the books, a company's deferred acquisition expense asset is automatically reduced (at least for those companies using the GAAP factor method), resulting in a charge against current earnings. This happens whether lapses are "normal" or higher than expected. If lapse and mortality experience are only a little worse than assumed, the provisions for adverse deviations included in the GAAP reserve assumptions may be enough to absorb the poorer than expected experience. However, if lapse and mortality are much worse than assumed, and are expected to continue to be worse than assumed, then the remaining unamortized acquisition expenses may no longer be recoverable over the future lifetime of the business. In this case all or a portion of the remaining acquisition expenses must be written off, creating a loss in the year this happens.

And this isn't the worst case. If future losses are expected on the business left in force, for example, due to severe mortality anti-selection, it might become necessary to recognize such future losses by setting up an additional reserve to cover them. This additional reserve would be a charge to GAAP earnings in the year it is set up. Loss recognition testing is supposed to be done on a "line of business" basis under GAAP, as opposed to the total company approach to the adequacy of statutory reserves. Thus it is conceivable that in some cases GAAP loss recognition on term insurance business will have to be dealt with even though the adequacy of total company statutory reserves is never threatened.

Another way of looking at impact of higher than assumed lapses might be helpful. Let us again assume that the company determines GAAP reserves using the reserve factor approach where the deferred acquisition expense asset is determined based on an inventory of the policies in force on the valuation date. When a policy lapses the immediate impact on the company's financial statements, either statutory or GAAP,is a gain(loss) equal to the net reserves released less the cash value paid out (if any). On a statutory basis the reserves for term insurance are small, assuming no deficiency reserves are involved, and generally there are no cash values. Therefore, the immediate impact of a lapse on the statutory financial statement is relatively small. Under GAAP accounting, however, the net reserve (reserve for benefits and expenses less the remaining deferred acquisition expense asset) is usually negative for a number of years, and hence the net reserve less the cash value is negative and a GAAP loss results at the point of lapse. This loss can be substantial if capitalized acquisition costs are high and the lapse occurs within the first few years after issue.

While on the subject of the impact of adverse experience on future financial results I would like to make a few brief comments on interest rates and inflation. High interest rates accompanied by high inflation are generally not a favorable scenario for term insurance. This is because term insurance reserves are relatively small, and hence the higher interest rates generate little in the way of additional investment earnings. On the other hand, high rates of inflation cause renewal maintenance expenses to increase. Inflation has subsided somewhat the last couple of years and this will be a plus for those companies that included inflation of maintenance expenses in the original pricing of their term insurance products. However, even a reduced level of inflation will be a negative for those companies that did not include an inflation assumption in their original pricing.

Some companies issued ART type products with indeterminate premiums in order to avoid deficiency reserves. These companies have the ability to increase

the premiums charged to policyholders, and it will be interesting to see if any of these companies take advantage of this possibility, although not the original intent of the indeterminate premium provision. Of course, increased premiums may tend to drive out even more of the healthier lives and lead to the type of assessment spiral more commonly associated with adjustable premium health insurance business.

One final observation on existing business financial results is to speculate on the impact of federal income taxes, particularly in the case of modified premium whole life plans sold in recent years. It is easy to construct a scenario under which a company might have been very aggressive in utilizing the net level election in its federal income tax return and then be fortunate enough to see its "net level overhang" forgiven under the Stark-Moore tax bill. Assuming the company has tax gains against which the tax losses on term insurance can be offset (or will have before its tax loss carryforwards expire), it may experience an after-tax first year gain rather than a loss on its term insurance business. And even if renewal lapses and mortality are very poor, losses on term insurance may be reduced by offsetting reductions in the company's total tax burden. Thus the after tax return over the life of such business could conceivably be positive even in the face of very poor persistency and mortality experience.

Let us now turn our attention to future issues and discuss the impact the industry's recent experience on ART type term insurance will have on the pricing of new products. Pricing actuaries, obviously, have become much more cautious than has been the case in the recent past, particularly where confronted with products similar to what companies have been selling over the last few years. However, most of us may be facing a little different problem, since from what we have heard earlier today, it appears that many companies intend to modify the design of their competitive term products, and the associated sales compensation, in order to avoid the structural deficiencies of many, if not most, of the products sold in recent years. The challenge to the pricing actuary will be to realistically assess the proposed changes and evaluate whether or not, in his opinion, he can justify the use of the kind of pricing assumptions necessary in order to produce a satisfactory anticipated profit margin. Fortunately for the pricing actuary, so many companies have been burned by the poor experience of the products sold in the recent past that the top management of these companies may not be as prone as in the past to accept overly optimistic evaluations of anticipated future experience. This should be a big help to the pricing actuary who wants to be rational yet reasonable in pricing new term insurance products.

We have all heard that reinsurers have regained their sanity in relation to the pricing of coinsurance arrangements for term insurance products. To the extent that reinsurers were subsidizing direct writers this should help to stabilize the marketplace.

Finally, the removal of the net level election, which at the moment appears to be a non-controversial portion of the pending federal income tax legislation, should also tend to stabilize the term insurance marketplace (at least until new loopholes to be exploited are discovered). Even though almost nobody would admit to building the net level election into pricing calculations for term insurance, some of the very competitive premium rates appeared to be very difficult to justify in the absence such tax considerations.

I would like to move on now to the last subject on our agenda for today's Open Forum: Interaction with Other Non-Traditional Products. These words probably mean something a little different to each of us depending on our background and our perception of the marketplace. When I think of non-traditional products, those that come to mind are Universal Life and Irreplaceable Life-type products, Variable Life, and the yet to be introduced UL II. Furthermore, my thoughts concerning the interaction of these products with term insurance reflect my own feelings that our industry's primary delivery system is expensive, and that there are too few really good agents out there and too many agents that are just getting by, if that. One result of this situation is constant churning of business by agents, particularly business written by other agents, but if it can be justified, their own business as well, in order to just survive in the business. Granted we've experienced high interest rates and inflation, along with improvements in mortality to which most older products weren't capable of responding; nevertheless, I believe we will continue to see relatively high lapse rates by past standards as new products come on stream and schemes are devised that make it look attractive to replace even recently issued business while at the same time generating new first year commissions for agents. A final point on this subject is that it appears to me that we have progressed to the point where many companies now openly encourage replacement of other companies' business, even to the point of designing sales programs and administrative support specifically to accomplish this objective.

I see aggressively designed and priced Universal Life being used to replace in force term insurance as well as competing with term insurance for new sales as long as interest rates remain high and allow projected premiums per $1,000 to be very low. I believe we are now seeing increased competition on Universal Life with the result that more attention is being given to the various parameters (particularly the level of mortality charges), and profit margins are declining. Perhaps we will soon see Universal Life plans designed to be used in lieu of term insurance. In summary on the subject of interaction of products, I feel that replacements have become a way of life now and we will continue to see relatively high levels of lapsation by past standards.

MR. JAMES A. ROBINSON: I would like to make two sets of comments and then I have a question.

My first comments are with regard to the indeterminate premium products. I'm wondering what companies are intending to do when they find out that the profit on a given product is not what was expected. Given a product is unprofitable, will they then raise the indeterminate premium? Is that appropriate? Is that equitable? Or should they be making changes across their entire ordinary line to take care of financial problems they're having. I suggest that would be more equitable. Let's say a company comes out with a product, "Super Term" and runs into some problems because they're moving the healthy lives over to "Super Duper Term". Five years down the line they want the original Super Term to show some profit, so they think, "well, let's raise the rates. They're indeterminate premiums and we have the right to do this." I'm suggesting that they should be raising the rates for both their old and new products across the entire ordinary line. I don't think the customer should suffer on account of the vicissitudes of one particular product.

I would like to mention the experience of my company as a counterpoint, U.S.A.A. is somewhat unique. We sell annual renewable term where the rates vary by attained age. We have some of the nice characteristics you're talking about on the new products to come, because we still have our old product and we never switched away from it. In a sense our commissions are level because we don't pay any commissions, we just pay a salary. Our customers do not have any incentive to re-enter because the rates are by attained age. There's nothing to be gained. What have the results been of offering such a product? Well, our volume increases, of course, have suffered. I expect we could have sold $200 million of volume more each year than we did in the past three to five years. We have sold over a billion dollars worth of term each year. But our profits have not suffered, they have been compounding roughly at a 20% clip. We have a mutual philosophy and, thus, our dividends will be going up again this year. Lapsation has been about 6% level.

We are looking at the single premium product. We have been thinking of taking three annual premiums, turning them into a single premium and offering a huge discount. We're wondering if that discount might be viewed as taxable income to the policyholder?

MR. JARRETT: Let me address the first question first on what companies will probably or could do when they have an indeterminate product and the experience turns sour. I think there are many ways to look at this question. One way is from our point of view, what we think we should do. In my opinion, it is fine to raise rates on a given block of business. Many companies are selling various indeterminate premium products with most of the business concentrated in the select and ultimate plan. I do not think that if the select and ultimate product is having bad experience and other indeterminate products are having good experience, that the other products should absorb some of that cost. I think the cost should be allocated to the block of business that incurred it, or that we expect to incur it.

The other side of the coin is the business and marketing decision. I think that's something that we should be a part of -- giving our input to our companies and our clients. But I don't necessarily think that the actuarial implications will override the business and marketing implications. So, whereas I think we can raise the rates, I don't necessarily think companies will raise the rates because of marketing and business decisions.

MR. DAHLMAN: One possibility in increasing rates is to increase the anti-selection problem. Similar to the assessment spiral more typical on adjustable premium health insurance. A second comment is I think mutual and stock companies are going to approach the problem a little bit differently just because of their very nature. I personally feel that it's appropriate to increase premiums on that kind of business even though it wasn't the original reason for having the premiums on a non-guaranteed basis. Obviously there is room for abuse there. Taking out the select lives and offering them new insurance and leaving the very poor lives and then increasing premiums substantially. I think that type of situation is not in the public interests.

MR. O. DAVID GREEN: If the premiums go through the premium deposit account, there is a taxable implication to the policyholder in reverse order -- small first, large later.

MR. WALTER N. MILLER: Conceivably your discount can be defended as having nothing to do with interest but purely a new triennial mode of paying premiums. I have two other brief comments.

One, on what the panel has termed the tail of the mortality curve and the fact that some attention needs to be paid to the effect of this on pricing. I have a feeling that with persistency even at the levels that were expected when companies first began to price this kind of product a few years ago, that even "normal" persistency is probably going to take care of a good deal of that tail of the mortality curve and keep it from being a very big element in the overall pricing equation for a block of business.

My second comment is unrelated. I was kind of surprised that there hasn't been much mentioned of conversions. If you want to talk about why are companies interested in having cheap or reasonably competitive term, one reason is because they want their agents to write that term in their company so the company can obtain the subsequent conversions. To me that's still a very important item in the equation. I know that to our agents who have been bothered about our term rates at the times when we have not been competitive, it is important to give them a decent term rate so they can write the term in New York Life so they can convert the business into New York Life. That's where they really want to convert the business. The policy owner is going to be better off and the agent is going to be better off. If New York Life has high term rates that forces its agents to place the term elsewhere, then we are impairing our agent's ability to convert the business into New York Life. I would also suggest that from a company standpoint, as long as you're offering a permanent plan of insurance that you think has reasonable profit potential, and let us hope that all of us are, that we don't think of conversion so negatively.

MR. JARRETT: Two major points there. One being the mortality tail and the lapse rates. It is true that the portion of business will be miniscule ten or fifteen years down the road. However, if you have mortality ratio of 1000% it doesn't take too many deaths to wipe out all of your premium.

On conversions, he made a very good point. I think in the competitive term market, there isn't necessarily a push to convert those plans to universal life or some sort of permanent product. I think that can be a source of profitability to the company.

MR. WELLER: On the long term tail, I agree that there's not much business left out there. The concern you need to look at is what reserve are you holding for the few lives that are left. If the premium isn't sufficient, the difference has got to come out of the reserve or the earnings of that year. If your reserve is sufficient, the fact that there are few lives left really shouldn't hurt you. I would guess that most companies probably don't have a reserve that is sufficient and if the premiums aren't sufficient then obviously the product is not supporting itself.

The second point on conversion, what you have to look at is to what extent your agents are in a market that they are not concerned about a first year term premium. As was mentioned at the term seminar yesterday, we are not talking about a premium level at which you can sell all you want and two cents above that, you can't sell any. There is a range of term premiums. If you're able to sell at the higher end of that range, you're going to have a much better degree of conversion, because the person is looking for a long term

insurance need. If you're at the very bottom end of the range for term insurance, in the 60 to 80 range, the first year premium is the critical factor that is generating that sale. I really question whether you're going to get any significant conversions from an 80 rate to a $10 rate per thousand.

MR. JOHN O. MONTGOMERY: We have been doing some testing on the 1980 CSO select tables and we seriously doubt their adequacy on annual renewable term, particularly at the ages under 45, because the loading in it is so small. We figure this may be one of the sources of earnings depletion being experienced for those companies that have used the 1980 CSO select tables. This is particularly true for some of the reinsurers.

MR. JARRETT: When you looked at the adequacy of the table, did you take into account mortality antiselection.

MR. MONTGOMERY: We ran some tests with expense assumptions and things like that and came out with the rather poor results. We're concerned that table may not be adequate on a select and ultimate basis for annual renewable term. When you add the excess mortality into it, it's clearly inadequate.

MR. DAHLMAN: The difference between statutory and GAAP is not just the mortality tables. Statutory reserving procedures don't really make provision for expected future mortality antiselection. On the other hand under GAAP, if the actuary assumes future mortality antiselection, that assumption is built into the calculation of the GAAP reserve factors. So at least there's some provision for future antiselection. On a statutory basis, that antiselection doesn't come into play unless the sufficiency of the company's reserves in the aggregate is brought into the question.

MR. MONTGOMERY: I think this is a significant role that the actuary must play in the analysis of these products in determining if the reserves are good and sufficient. If this annual renewable term insurance is a significant block of business for the particular company or an increasing block of business, they really have to take this block of business separately to see if it is going to create a future drain on the company.

MR. JARRETT: So what I hear you saying, John, is for ART products, the 1980 CSO and traditional reserving techniques may not be appropriate.

MR. STEVEN R. LINNEY: It seems the only theory for select and ultimate is that you want to pass on the benefit of selection to the customer. If he is reunderwritten every year, there's a benefit there. I really question whether that's true when you actually look at all the expenses. In other words, as you do more financial underwriting and whatever, are the underwriting expenses going to go up. But specifically, I'd be interested if anybody has a sense of what "leverage" you get from underwriting expenses. How much gain from mortality do you expect from underwriting. And in fact, I would suspect it may even be negative.

MR. JARRETT: On your first point, I think the select and ultimate scale came out not really to benefit the customer, but to come up with a low going-in cost.

MR. WELLER: As far as underwriting expenses are concerned, in talking with one of the reinsurers, they said a lot of underwriters will look at what the premium is and underwrite to that level of expenses. So that if you have a small premium and a very high risk, they will underwrite less than if you have a fairly large premium and a fairly small risk. Which obviously is not what pricing actuary intended at all.

The point that I was making in terms of financial underwriting is there appears to have been some very large increase in the level of accidental and violent deaths in the early durations, well more than what you would have expected from the first or second year of a select table. So the question that you come up with is what are the causes. One of the explanations that was made yesterday was that if the term rates get low enough, you hit a point where the gambling instinct takes over and it's worth the gamble. I basically have to question that idea, to the extent that the person is writing it on himself. If you're writing it on somebody else and you can get the insurable interest through then that may make sense, but I, for one, would not want to gamble on my own life. Another explanation that I've heard is what's called the "Macho Million" approach. The idea being able to say that you have $1 million of coverage is really wild and makes you a lot bigger than you really are. This gets into the economic status that I was talking about. People are able to afford the first year premium on a $1 million of insurance when they don't need it. However, the agent is not going to walk away from that premium. Basically, the underwriting department has to ask whether he is going to be able to afford the third year premium. If the premium is increased by 60% in two years I would guess that most people's income hasn't increased by 60%. Therefore, you end up losing that business.

MR. DAHLMAN: I think from a cost efficiency standpoint the gentlemen's comments are well taken on smaller policies. But on the larger policies, like over $1 million there's an opportunity for the company to be whip-sawed. That's where the experience has been most unfavorable to date, the lapse and mortality experience. So I suspect there is a good cost/benefit at the higher amounts.

MR. DAVID B. ATKINSON: I'd just like to be on record as saying that I have no convictions about changing indeterminate premiums after issue. When our company issued such products, it was with the idea that should experience get better or worse, we would change the premiums up or down. I doubt that we'll be the first company to do it, but it could happen this year.

Secondly, I'd like to put the three of you on the line and ask you to describe the kind of term product you would develop today. All the various characteristics. You have described a lot of possibilities. I'm just curious what each of you individually would do.

MR. JARRETT: First of all you have to look at your company's posture and where you want to be. That's really a management and marketing choice rather than an actuarial choice. We can give them a lot of input on the implications of their choices or alternatives, but again it's a management choice. Let's take the scenario where I as a company decides, I'm going to be in the competitive term market. In the short run, it's very possible that I won't make a profit or I'll put business on the books that will not be profitable in the long term. However, I have decided I am going to be in this market, I'm going to be one of those 10 or 15 companies that becomes expert in this market. So then what do I, as a company, do over the short term. I may say I will try to cut my losses as best as I can while still trying to keep that agency relationship. So what I do is cut the term period to reduce the long

term risk to the company, and come out with a short term product. I may decide to come out with more than one product to fill several needs. Hopefully, I can wean some of the agents away from the low premium select and ultimate version with the high front end compensation to other types of products. But, I still have to remember that I'm trying to keep my marketing force so there's always that market constraint of the premium level.

It's also true that by doing nothing, every day your product becomes more competitive. So there's always that alternative. To do nothing for a while and see what happens. I don't think that is necessarily the right choice. I'd like to see companies cut off that long term risk and institute some programs to improve persistency.

MR. WELLER: The question is relatively easy in terms of what I'd like. I'd like to have an ART product, sold by salaried people, and generating a 20% increase in profit each year. I don't know of any other company that is in that position, but that would be what I'd like. Realistically, given that you're in a market where the insurance is sold by agents who make their living on it, you have two concerns. One is that you maintain a relationship with those agents -- they have to live, too. It's easy for us in the home office getting a salary to say we can cut the commissions. But it really hurts the guy out in the field who has to make a living. He's been used to getting a front end commission. I think that the two things that I would suggest in the way of products are what Ed just mentioned. Firstly, shortening up the period. Secondly, to get the agent involved in the persistency, either by reviewing very closely what your agents are doing or persistency underwriting and then looking at how that relates to an agent.

MR. DAHLMAN: I'm afraid my product wouldn't sell, at least for companies active in the competitive term market. I would lean toward the five and ten year level premium nonrenewable term plan with level commissions, or maybe a somewhat higher first year commission. Like I said, I think for most companies that are active in the market, that product's time hasn't come yet. In most of the client situations I get involved with, the bottom line is not an actuarial pricing decision. It's a marketing, company management decision on where we want to be and where we have to be at the moment. From an academic or theoretical standpoint, I'd like to try and come up with a universal life design that provides reasonably attractive term insurance premiums in the early years. That is, the cash values of the UL are zero every year. Then, ultimately, it can be used as a conversion vehicle into a permanent product.

MR. JOHN W. TOMLINSON: A question for Mr. Weller. I seem to recall you saying that there is some indication that accidental deaths are high on this low premium term insurance. I think you also said that there's no real mortality experience on re-entry term and I'm wondering if I heard you correctly. If there is some mortality experience, I'd certainly be interested in hearing what it is. I do know for example, the intercompany mortality committee that publishes the annual mortality study has the problem of whether the annual contributions from the contributing companies should include or exclude re-entry term insurance. It's feared that mortality will be excessively high on this business and this high mortality might distort the overall experience that's being published each year for regularly underwritten business.

MR. WELLER: In terms of the accidental death, let me mention that what I said with regard to mortality experience is not based upon my own company. It comes from reinsurers who are generally pretty willing to discuss it in general terms and whose experience tends to be a lot broader than what a direct company might have. I believe that in the records from the last Society Spring meetings, there was some information on AUL's experience on the accidental risk which showed they had significantly higher percentages than what they would have expected on select lives.

With regard to the re-entry, my comment was that the re-entry causes antiselection and results from continually taking out select lives who can re-enter at new rates either with your company or with some other company. When you take those lives out you get a group that is not going to end with up ultimate mortality. It's going to end up something higher than that. We are probably ten years away from seeing rates in excess of the ultimate rate and in 15 years we will probably be somewhere around double the ultimate rate and then it gets worse from there.

MR. ARMAND DEPALO: I'd like to make a few statements that the structure of the company and its marketing force weighs very, very heavily on what products you sell. Being a mutual company, and also being a mutual company with very strong commitment to the career agency force, the products we need can be drastically different than those of a stock company or a company dealing with the brokerage market. Guardian has found the attained age product to fit more neatly into its product portfolio than a select and ultimate product ever would. We can control persistency because we can watch what our agents do. The majority of our business comes from our own agents. If you don't have that structure, I strongly doubt you can really market a term product and have it be profitable.

The other comment I have is on the 1980 CSO select and ultimate table. The mortality rates in that table do tend in some cases to be low. However, if you use the select and ultimate rates and convert your reserves to an increasing premium structure, then you have, in addition to your half of the net premium reserve, an increasing term reserve. That reserve increases to the 15th year and runs out in a very nice pattern after that point, releasing profits to allow you to afford some of the extra mortality. I've been giving very serious thought that if we do move to the 1980 CSO on the YRT products to using the select and ultimate mortality and consider my product an increasing premium product so that I can have this reserve increase. This is not for tax planning,it's purely for adequate reserving and it does produce an adequate reserve.

MR. FRANK J. ALPERT: We have a select and ultimate term and we have the same kind of captive agency force which I think does improve our persistency on the policy. We do not have agents that are chasing the absolute lowest dollar, which is fortunate because they wouldn't sell our plan. We have a good term plan but it is not a super term plan. We did increase our premium rates on January 1st of this year for new business. We have not found it necessary to increase the premium rates on the old business yet. I think that I would move very cautiously because it might aggravate any problems that there were in that line of business. I might say that when we came up with our new

pricing for this year, we built into it the mortality antiselection on the increased lapses. We had observed much heavier lapses on the ART than we had on other term policies. We built into our new pricing, the mortality antiselection arising from the higher lapses on a theoretical model. It is true that this first becomes really evident years out, but it is inevitable and very heavy by the time you get around to seeing it.

MR. ATKINSON: Last year in Chicago, Steve Radcliff showed some numbers on the screen about his company's actual and expected experience on select and ultimate reinsurance. I think that the first year ratio was something like 100%, second year 130% or so, third year about 160%. The third year may have been a fluke, but it probably does indicate that mortality is getting worse with increasing duration compared to what they were expecting. I'd like to ask the panel to maybe quantify some of the lapse variations by year, especially after the third year, that they've observed and also by size of policy.

MR. JARRETT: The business isn't very old yet, but I think as long as the product's on the market with premiums so much lower than what the policyholder will be paying in years three or four, they're bound to be rewritten. There is the argument that by that time your so called 90% standard lives have already left, what you've got left are substandard lives. Then, you must look at the level of the premium versus the level of a new premium for a substandard life. What it means is you're not just taking the standard lives out, you may be taking some lives through table 4 for example and at the latter durations, through a higher table. Therefore, at some time almost everyone is in a better position if they go out for a new select and ultimate term policy even with a substandard rating. Consequently, I think that the lapse rates will stay relatively high but will come down over the long term.

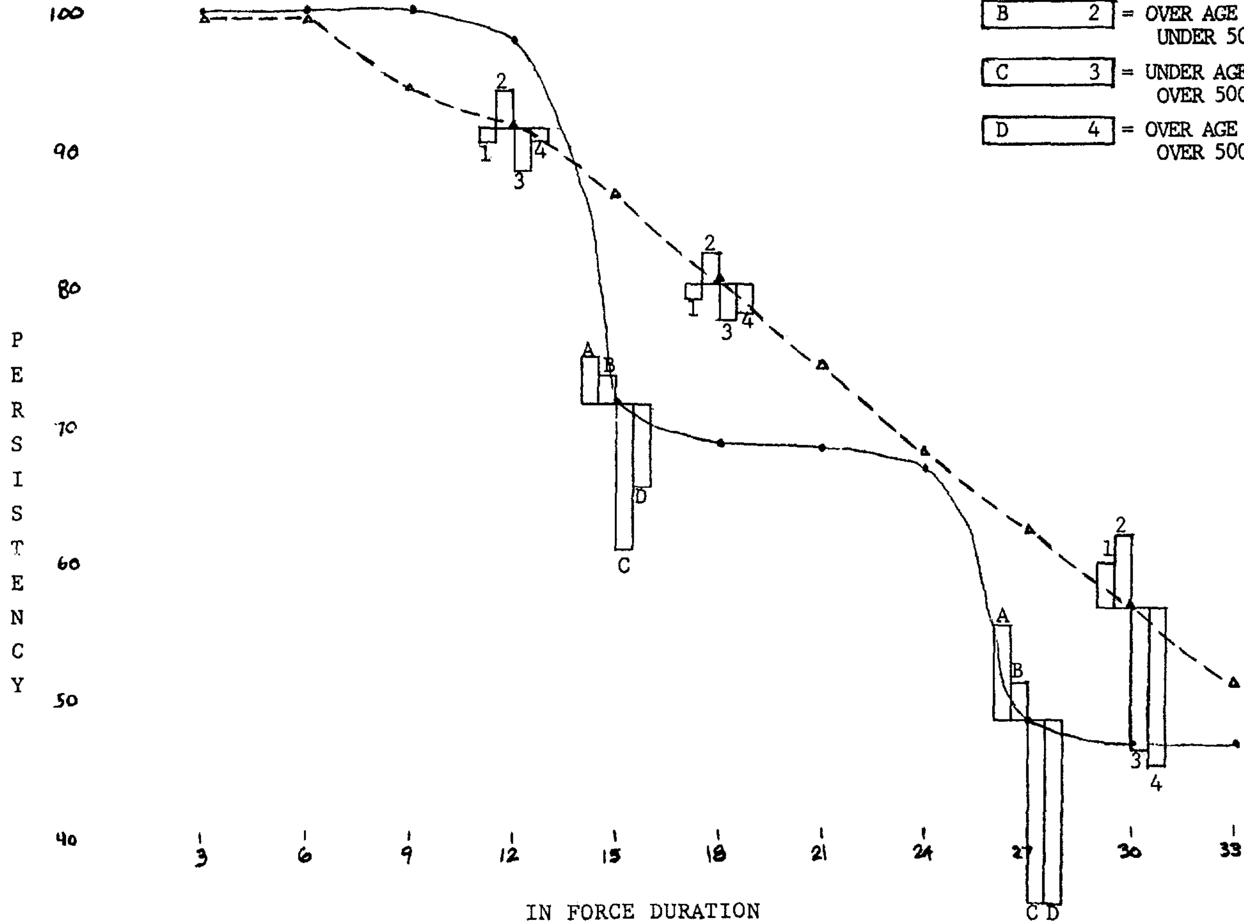
MR. WELLER: Some companies have found that if you take out a base lapse rate, the rest of it correlates very well to a percentage (75-100%) of the premium increase. So if we assume a base lapse rate of 10%, and your premium increases 25%, you'll get about a 30% lapse rate. If your premium increase is 40% you'll get lapses of around 40-45%.

MR. DAHLMAN: In the limited situations that I've been exposed to, mostly with smaller stock companies, we've seen lapse rates on the order of 20% to 25% first year, for select and ultimate ART type plans with steeply sloped premium schedules and high/low commission schedules.

Second year lapse rates may be 30% to 40%, and we really haven't gotten much beyond the second year. I would like to make a couple comments about some of the things that have happened over the last five years that have contributed to the term war. One, of course, is improving mortality overall which started it off by bringing attained age ART rates down. Then we had the switch to non-smoker/smoker rates. Then to select and ultimate ART rates and then increased competition at all levels that have driven down profit margins and driven down the prices. I think you can build a case for the fact that maybe the worst has been seen and persistency is going to get better. On the other hand, given where we are, that seems a little bit "pie in the sky" and I wouldn't bet my company on it.

MR. CRAIG M. BALDWIN: Based on most recent information that I've seen at General Re, we haven't seen a dramatic increase in the accidental death claims, probably because the underwriters have been stressing a review of motor vehicle records, and so forth, and trying to get the underwriters at other companies to do the same. But our overall first year mortality experience on the term is running roughly about 140% of expected.

MR. WELLER: In our review of our graded premium whole life plan for amounts in excess of $500,000, after two years, we had less than 40% of our annual premium policies in force.


GRADED PREMIUM WHOLE LIFE
ANNUAL OTHER
A 1 = UNDER AGE 40 UNDER 500,000
B 2 = OVER AGE 40 UNDER 500,000
C 3 = UNDER AGE 40 OVER 500,000
D 4 = OVER AGE 40 OVER 500,000
PERSISTENCY
100
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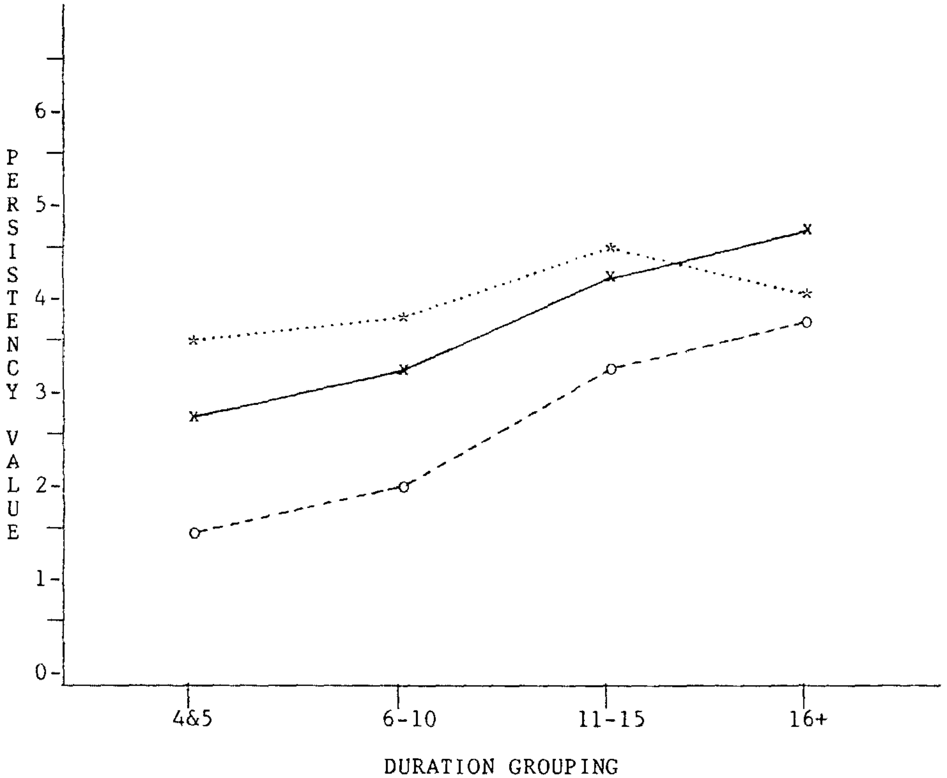
WEIGHTED VALUE OF EXPOSURE CELLS BY TERMINATION RATES
PERSISTENCY VALUE
0
1
2
3
4
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6-10
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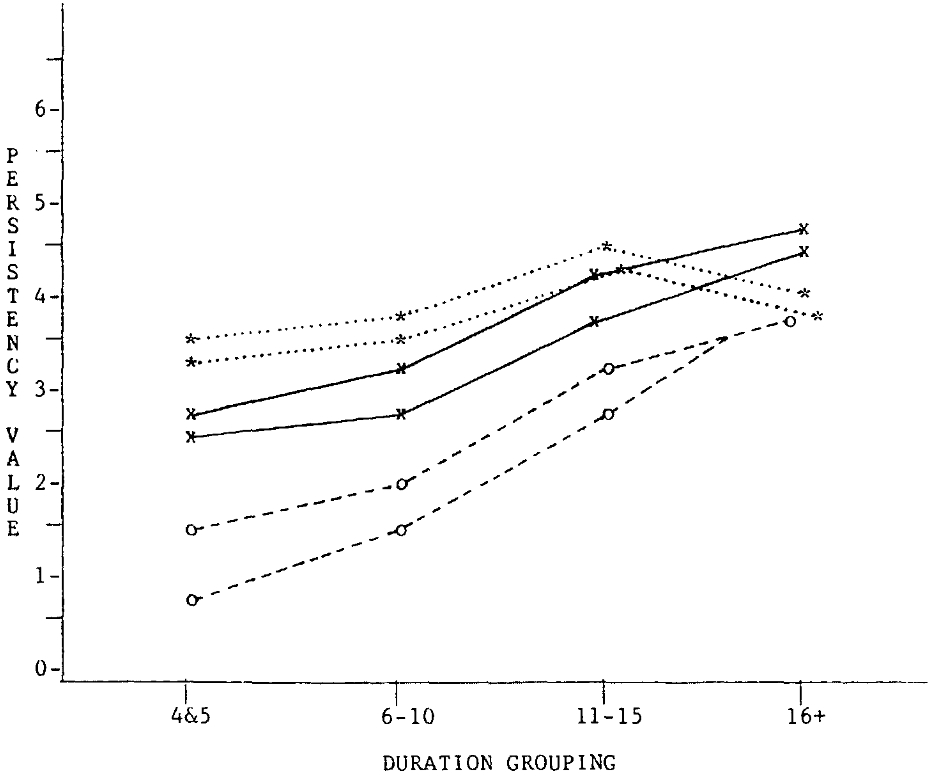
16+
DURATION GROUPING
x——x Permanent (4 = termination rate of 7-10%)
o-----o Renewable Term (4 = termination rate of 11-15%)
······· Decreasing Term (4 = termination rate of 11-15%)

WEIGHTED VALUE OF EXPOSURE CELLS BY TERMINATION RATES
1978 - 1983 EXPERIENCE VS. 1982 - 1983 ONLY EXPERIENCE



x——x Permanent (4 = termination rate of 7-10%)

o-----o Renewable Term (4 = termination rate of 11-15%)

······· Decreasing Term (4 = termination rate of 11-15%)

1978 - 1983 EXPERIENCE

PERCENT OF EXPOSURE CELLS WITH UNACCEPTABLE* TERMINATION RATES

DURATION	PERMANENT PLANS	RENEWABLE TERM	DECREASING TERM
4 & 5	29%	68%	15%
6-10	22%	55%	4%
11-15	4%	28%	14%
16+	4%	17%	14%

*UNACCEPTABLE FOR PERMANENT IS >15%

UNACCEPTABLE FOR TERM IS >21%

1978 - 1983 EXPERIENCE

&

1982 - 1983 ONLY EXPERIENCE

PERCENT OF EXPOSURE CELLS WITH UNACCEPTABLE* TERMINATION RATES

DURATION	PERMANENT PLANS		RENEWABLE TERM		DECREASING TERM	
	TOTAL	82-83	TOTAL	82-83	TOTAL	82-83
4 & 5	29%	28%	68%	94%	15%	29%
6-10	22%	28%	55%	63%	4%	0%
11-15	4%	14%	28%	40%	14%	16%
16+	4%	5%	17%	7%	14%	16%

*UNACCEPTABLE FOR PERMANENT IS >15%

UNACCEPTABLE FOR TERM IS >21%