RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 4B

TERM INSURANCE: OUTLOOK FOR 1990

Moderator:	JOHN E. TILLER, JR.
Panelists:	RAYMOND A. BIERSCHBACH
	GARY N. PETERSON
Recorder:	ANGELICA B. MICHAIL

- o Experience and trends
- o Product design alternatives
- o Conversions -- risk or opportunity?
- o Underwriting for persistency -- is it worth the effort?
- o AIDS considerations
- o Reinsurance -- friend or foe?

MR. JOHN E. TILLER, JR.: The official title for this program is "Term Insurance: Outlook for 1990." A better title might have been "How to Prepare for 1990." I do not think you will find a lot of people saying "Here is what's going to happen," but we would like to explore ways to position yourself in the modern market and have a current product that is valuable in 1990.

EXPERIENCE AND TRENDS

Between Washington's proposals on changing the tax laws and recent events in the stock market, potentially doing damage to variable products, we may end up with term insurance being the only game in town. I am not predicting that. I hope that is not true, but it could possibly happen.

Let's go back 10 years to the period of 1976-77 when companies such as Transamerica started introducing products called ART to 75 and ART to 100. Two years after that, the first of the select and ultimate term products hit the marketplace, and it seemed just 30 seconds after that we had one year re-entry term. In 1981 we introduced, on a very wide scale, nonsmoker products and preferred risk discounts. Note that the trend in each step is less money for death benefits, less premium per unit, and less premium per risk. By 1982-83 we were heavily into replacement programs and term churning, i.e., moving term policies from one company to another or taking term polices and converting them to another company's universal life. This term war was a mess many of us lived through.

At that point we saw a number of companies that had annual lapse rates in the range of 40-45%. In 1983, the reinsurers started to tighten up and introduced more stringent persistency requirements and different underwriting requirements. Somebody said that sanity returned to the marketplace. I do not know if sanity returned or if the insanity rate decreased. We continue to see companies offer even cheaper term insurance products. We continue, as an industry, to have concern about persistency and mortality.

MR. GARY N. PETERSON: Those of you who were at the 1983 annual meeting in Hollywood, Florida, may recall the keynote speech. Futurist Dr. Leon Martel told a story about the Global 2000 Report to the President of the United States during the Carter Administration. He said,

> This is a huge report. It is the size of a big city phone directory, about 1,000 pages long. It begins with these four words: "If present trends continue. . . ." At that point, you can stop reading. If history teaches us anything, it is that present trends never continue.

Therefore, we must look beyond recent trends towards the reasons for them. Only in this way can we begin to see when trends may change.

Recent mortality studies indicate that the difference in experience between term and permanent seems to be narrowing. However, the disproportionate number of jumbo amounts written on term plans could mean that anti-selection is merely weeded out by the greater number of underwriting requirements on relatively larger term policies. And the low term premiums of the last few years have drawn more of what were formerly considered permanent insurance buyers into the term market. Will that market mix continue? In addition, we must contend with the specter of future AIDS claims.

I have a couple more examples of where you must take care in applying current experience data. The average policy size in the latest Society of Actuaries term conversion study (experience between 1971 and 1978 anniversaries) is $15,000.

This experience is probably not indicative of the markets in which you are working. Another observation is that lapse rates on term policies seem highly dependent upon both the product design and the distribution system through which they are sold. For example, select and ultimate product designs encourage re-entry, either internally or through another carrier. Career agents seem less disposed to replace their own business than brokers, though I am sure there are many exceptions.

The popularity of term insurance among buyers and the positioning of term in any company's marketing package depends on events and perceptions that I can't predict. For instance, take the economy. The relationship of interest rates and inflation made term insurance look like a good deal relative to permanent insurance a few years ago. In more stable times the market seems to swing back toward level premium forms.

Taxes are extremely important. The Section 818 (c) loophole in the old U.S. tax law made it possible for many companies to price extremely competitively. Now that is gone. If the government decides to tax the inside buildup of cash value policies, you don't have to be clairvoyant to see that the market for low cash value and no cash value forms will grow, inviting more intense competition.

Each company's management's perception of business risks has a lot to do with marketing thrusts. Fifty to a hundred years ago, companies didn't want to sell term: in part because of the relatively small size of companies and the lack of availability of reinsurance, term was viewed as too risky. Of course, after the interest rate roller coaster ride of the 1980s, many companies now view accumulation products as more risky. AIDS may change that perception again.

I believe that the current retrenchment of term writers will continue into the 1990s. Many companies have already dropped or modified their select and ultimate YRT plans in an attempt to improve persistency. There is some movement toward level commission scales on term and other plans. And underwriting requirements are becoming more restrictive, at least with respect to AIDS and smoking.

MR. RAYMOND A. BIERSCHBACH: My comments on this portion of the agenda will apply to the direct side as opposed to the reinsurance side of Transamerica

Occidental. The direct side is in the process of completing a mortality study of their select and ultimate product for the period of 1981-85. That study is already raising some questions which may not even be answered until the 1990s. While the overall mortality was quite close to expected, mortality did tend to be higher in the larger bands. Was this due to renewal anti-selection, with the larger cases moving annually or perhaps every other year? Alternatively, was it due to anti-selection at initial underwriting? There seem to be some indications of renewal anti-selection; however, they are as yet not specific enough to give a clear indication of what the degree of that anti-selection will be. In pricing, they do build in a renewal anti-selection factor.

This study enabled the direct side to quantify the effect of AIDS claims over the period of the study. However, is this a valid prediction of the future?

When pricing assumptions were originally set, the then best information was used to differentiate between smoker and nonsmoker mortality. The current study shows nonsmoker mortality worse than expected, smoker mortality better. Is the ratio of smoker mortality to nonsmoker mortality lower than previously thought? They think so.

In summary, some of the factors affecting mortality conditions are so recent as to make it difficult to predict future trends.

MR. JAMES W. PILGRIM: Our experience on term reinsurance shows a couple of things. First, the renewal lapse rates are actually higher than the first year lapse rates. It seems the product is parked for a while and then is rewritten in some other company. We also see an increase in the term mortality at renewal similar to what Mr. Bierschbach referred to. The other thing I find interesting is that some companies currently writing universal life with select and ultimate cost of insurance rates are really writing term insurance under a different wrapper. We are getting the same kind of experience under those products as we have seen under select and ultimate term products, and it is a function of how steep the scale is of the cost of insurance rates. The steeper the scale and the more rewriting you do, the more anti-selection you have on renewal.

MR. TILLER: Are you seeing any lowering of overall lapse rates? I referred earlier to the 1982-83 figure of 45% a year for certain companies.

MR. PILGRIM: We have lowering lapse rates for recent issues. Our book of business is pretty small. We have a favorable fluctuation in our old business that was underwritten in the heyday of very liberal underwriting. We would rather see those policies lapse than stick around for us to pay a death claim. I never thought I would be in a position where I was encouraged by high lapse rates. To answer your question with regards to more recent issues, yes, our lapse rates are lower than a few years ago.

MR. LAWRENCE SILKES: Using a steep scale in the design of select and ultimate products encourages conversions. Did you ever in your design at Transamerica Occidental anticipate conversions and make the scale steep enough so that at some point it is more advantageous to convert the policy than to maintain the term policy? We find at National Benefit that we get around 30% conversions starting at the third year when the scales become steeper. So it is advantageous that the select and ultimate scale has a sales appeal other than to turn around and sell another term policy.

MR. BIERSCHBACH: The direct side people have not yet figured out a way to conveniently move people from select and ultimate directly into a converted policy. It seems that it is a little easier for those people to move back to select and ultimate product.

MS. ALICE M. NEENAN: On the smoker/nonsmoker mortality, you commented that the nonsmoker mortality was worse than expected. Do you think that it is because a lot of smokers are being underwritten as nonsmokers? Our experience has been that the percentage of term business written for nonsmokers is significantly higher than permanent. We are even thinking of going from non-cigarette smoking to non-any-kind-of-smoking to try to deal with that. I wonder if you had any evidence that, in fact, your problem was a lot of smokers getting in the nonsmoker class?

MR. BIERSCHBACH: There is no hard evidence that is what happened, although there is a strong suspicion. It may also be that people have given up smoking long enough to qualify for nonsmoker rates, but the adverse mortality is still hanging around there.

OPEN FORUM

MR. PETERSON: Just to give a different point of view, our recent mortality results indicate that we underestimated our smoker mortality and that our nonsmokers are actually doing better than expected.

MR. FREDERICK S. TOWNSEND, JR.: As an insurance buyer, I have switched every year for 12 or 13 years. Obviously when the premium rates jump 40% in the second year it is nice to go in and re-qualify. Companies have to find their way out of this hole.

Recently, we ran across a company we are doing some investment banking work for. They give a re-qualification examination, or offer one, on every second policy anniversary following date of issue; i.e., on the second, fourth, sixth anniversary etc., the insured is offered the opportunity to take a new exam and stay with select rates. As a result, until the insured is about age 65 he never has a double-digit increase in the premium rate. The aggregate lapse rates for the entire company are running less than 10% in each of the last five years. About 90% of their insurance in force is annual renewable term. I think that much of the persistency experience is heavily influenced by the percentage increase in the premium rate. This is the challenge in finding your way out of a product which is based on a select and ultimate rate scale.

MR. TILLER: You did an excellent job of illustrating Jim Pilgrim's point that the slope of the rates is important. The other side of that is those who don't re-qualify must have horrible mortality. Can you possibly charge enough for that group?

CONVERSIONS -- RISK OR OPPORTUNITY?

Conversions have played a major role in planning at Transamerica and Northwestern Mutual. One of the things that is unique about these companies is that they specifically look at the cost of the opportunities associated with conversions in designing their term products. From both my current experience as a consultant and prior experience as a reinsurance peddler, I found that a number of companies did not look at the cost of conversions and did not have adequate statistics on that.

What are conversions? Are they opportunities or are they simply extra risks?

MR. PETERSON: My company views them as both. It has a major marketing thrust to convert term to permanent insurance. There are two reasons. First, management has a strong belief that permanent insurance provides better value to most policyowners in the long run. Second, commissions on conversions provide extra income to the field. This is important because the company's field force is viewed as a major competitive strength.

The challenge is to price the conversion right competitively but without affecting the pricing of permanent plans. Management's philosophy is that permanent policyowners should not subsidize the mortality experience of converted term policies. Every study I have ever seen has shown mortality anti-selection on conversions. This is the result of what I consider rather irrational decision-making on the part of term policyowners, but it nonetheless exists. After all, why, if you knew you were in poor health, would you choose to pay more for your life insurance?

Anti-selection usually wears off rather quickly by duration since conversion, and the amount of anti-selection decreases with the length of the coverage period and the length of the conversion period, and also decreases with increases in rates of conversion.

A good way to manage mortality anti-selection is to encourage conversions. You can offer credits against the first premium upon conversion, allow conversion to larger amounts without additional underwriting, or advertise and promote the conversion right to owners of term policies in force. You can adjust field compensation to encourage conversions or run agency contests (provided you're not a New York licensed company). And the best enticement to conversion is to have an attractive permanent product.

Of course, converting all the good lives leaves only the bad lives behind and might drive your term mortality higher.

An additional risk arises to companies offering a contractual right to immediate conversion when premiums are waived for disability. If you don't maintain proper issue limits or if you allow conversion to high premium permanent plans, you can provide an unintended disability income from the cash value increases and dividends of the converted policy. You can obviously reduce this risk by limiting the conversion right during disability.

MR. BIERSCHBACH: At Transamerica Occidental, conversions have a three-phase history. Twenty to twenty-five years ago conversions were like apple pie and motherhood. Conversions by definition are good. We paid full commission for conversions, periodically had contests to encourage conversions, and made no specific pricing for the conversion privilege within the term policy. Most of our term policies had conversion privileges which expired prior to expiry of the term product so we felt that was all the protection we needed. We did not build up any extra reserves for extra mortality on converted policies. We were, however, setting up an extra reserve for extra mortality at renewal of term policies.

Sometime in the late 1960s and early 1970s, we started to do some studies on conversions by comparing their profits to that of the remaining block of in force term policies. We did this by paying attention to both mortality and persistency assumptions. The first time we did it, we made the mistake of assuming that the persistency of the converted block would be like the persistency on direct new business for permanent policies. We corrected that because we knew our persistency on converted policies was much better than the persistency of direct new business. When we completed some of those studies, we reached the conclusion that some blocks of business were best left alone. We were better off leaving them on term than trying to move them to permanent. That was a real shock to the corporation, especially to sales, where we had been pushing conversions for all those years and then no longer pushed them. While we wouldn't actively discourage them, we certainly were not going to actively pursue them. That was hard for a lot of people to take. At that time we started pricing conversions by putting a charge for the excess mortality to the term product. We started to build up conversion reserves within GAAP and we generally downplayed the importance of conversions. Now that we have come full cycle, some of those studies have been repeated, and the profitability of the more recent term blocks is not nearly as great as the predecessor's block. Therefore, the more recent studies indicate it would be to our benefit to encourage conversions again, even though the permanent policies to which they would be moving are probably less profitable than the permanent policies they would have been moved to 10-15 years ago. Nonetheless, the study shows that once again, we should encourage conversions, and we should be looking at ways to try to do that.

MR. ALAN F. HINKLE: Regarding methods of encouraging conversions by paying out conversion credits, do you pay commissions on those credits or do you pay commissions on the net?

MR. PETERSON: We had conversion credits for a long time, beginning when we had level premium renewal term policies. We released a reserve and that was a credit, but the agent was given credit for the entire premium paid and we paid a commission on the entire premium paid. We still do that. We pay commission on the total premium, not the net.

MR. TILLER: I think that is fairly unique. From what I have seen, most companies pay only on new cash.

MR. BIERSCHBACH: John, when we had the identical credit that Gary is talking about, we paid the full premium also, but at times we have instituted a special credit and only paid on net.

MR. HINKLE: Regarding mortality on conversions, you mentioned that it got back to the normal new issues at a very short time. How much of a swing did you have in your early years?

MR. PETERSON: It's been a long time since I looked at it, though it seemed to me that the first year after conversion the amount of anti-selection was astronomical, well over double of what you would expect. My recollection was that within about seven years the anti-selection effect has worn off. That is not to say that we were not getting higher mortality than we would have gotten on a new issue because the term policy was issued some years earlier. I'm just talking about the anti-selection involved -- that it seems to wear off in about 7-8 years and very quickly.

MR. SILKES: Part of the problem, I think, is that select mortality is a little distorted. In the first year there is a lot of first year selection that does not include incontestable claims and suicides which you cannot have in converted policies. All of a sudden you go into conversion and those two items that are normally out of your selection are in. That might be why your conversion mortality is a little higher. And to some extent you are in a later duration. Did you ever price your product assuming it was designed for conversion? That is, did you have term/term/term, then convert it and see if that was a profitable item?

MR. TILLER: We have done work on that recently for a couple of clients. It makes a significant difference. A company wanted to have a very competitive term product that would have 25-35% conversions per year for the first four or five years. It was to be an agent-owned reinsurance company. The cost of conversion was fairly small. They later decided to scrap the agent-reinsurance concept and developed another product with more traditional conversion rates of 1-3% a year. The cost went through the roof.

One question I have concerns reserves. Do people set up conversion reserves on a pre-conversion or post-conversion basis? Is this done on both the statutory and GAAP sides?

MR. BIERSCHBACH: On the GAAP side we set up both pre- and post-conversion reserves. I can't remember what we did on the statutory side.

MR. PETERSON: We also set up both pre- and post-conversion reserves. We don't have GAAP accounting, just statutory. I think the prime motivation was for tax planning.

MR. TILLER: From our work, it is definitely required from a GAAP side. If you're looking at much anti-selection, you will find that a prudent actuary should seriously consider statutory reserves.

Is there a difference in philosophy among any of you about who should bear the cost of conversions? Should it be the term or permanent product?

One issue in conversions has to do with affordability. People do have different economic circumstances at different points in their lives. For example, they need a certain amount of death benefit, but they can only afford so much premium now, so they buy the term policy and in 3-5 years make the conversion when the economic situation changes. If you have that type of a sale, your results will be different than if you priced a term product with a conversion option and somebody comes along and happens to convert. Quite simply, that's the message.

TERM INSURANCE: OUTLOOK FOR 1990

MR. TILLER:

UNDERWRITING FOR PERSISTENCY -- IS IT WORTH THE EFFORT?

Let's go back to 1983 when the reinsurers introduced the concept of taking a look at the movement of insurance policies. I remember one legendary story of a reinsurer in which a policy was moved from one company to another four times in five years. Since the policy was issued as a new policy each time and the reinsurer paid the typical 100% first year allowance, the reinsurer provided four years of coverage for absolutely no premium and incurred a lot of expenses. For some reason they felt that wasn't fair! Certainly it wasn't profitable, but maybe we should leave fair and equitable out of it. The reinsurers then introduced the concept of reducing allowances if the policy moved in the second policy year or if it moved two times in five years.

Persistency standards were introduced to correlate to the pricing. Supposedly these turned around the term war and toned things down. I'm not sure that is absolutely true.

What has been done with respect to underwriting for persistency? We talked a little about mortality, but my own opinion is that persistency is a far worse problem in the profitability of a term insurance product.

MR. PETERSON: The program asks, "Is underwriting for persistency worth the effort?" My response is that it depends on whose effort. I don't have any personal experience with persistency raters, so I don't know how well they work. My understanding is you can't make them work. My company underwrites for persistency, but indirectly at the field level. Agents, once they have gained some experience, can get a feel in each case from the fact finding interview whether a prospective term buyer has an extreme short term need, or is likely to lapse early, or will never convert his policy. In those cases, our agents will generally write a term policy from one of the more competitive brokerage companies.

The agent has several incentives to do this. First the renewal commission rate that the agent earns on all of his business depends on the persistency of his business. Second it's easier for the agent to sell the lowest premium term policy to a confirmed term buyer. Third it's easier for the agent to convert a term policy to a more competitive permanent product, which we feel we have.

OPEN FORUM

MR. BIERSCHBACH: In about 1983, our direct line tried a form of underwriting for persistency. We did not refuse coverage to anyone who demonstrated a pattern of frequent moves, but we reduced compensation when such a pattern was evident. We could not demonstrate that the business issued during the time we were underwriting for persistency had a lower lapse rate than the business issued prior to that period. Costs lowered, but not appreciably. We no longer do this form of underwriting for persistency because it didn't seem to benefit us greatly and it certainly wasn't popular with the field force.

MR. TILLER: Have the rest of you seen any underwriting for persistency programs at work? Gary's comment that the Northwestern Mutual agents will take their less favorable or more suspect cases down the street to one of the other companies may be one of the leading reasons that brokerage companies tend to have higher lapse rates than career agency shops. I am not sure the agents produce worse business. They are just more selective about where they put it. One company's broker is another's career agent.

MR. BIERSCHBACH:

AIDS CONSIDERATIONS

Term insurance is probably a target for AIDS anti-selection, more so than permanent insurance. Our direct side has done a mortality study on their select and ultimate block. This mortality study has shown that there has been about a 4% increase in mortality over a 4-year period which is directly attributable to AIDS claims.

In more recent pricing and special studies, our individual actuaries are relying heavily on two reports -- "AIDS in Life Insurance," by Michael Cowell, and "HIV Mortality," by Walter H. Hoskins.

We find that companies are lowering their non-medical limits in order to do blood tests for smaller amounts. We have done this on the direct side and we encourage it on the reinsurance side. On facultative business we are encouraging our automatic clients to lower their non-medical limits and start to give blood tests at a lower level.

MR. PETERSON: As the population in North America becomes more alarmed by the threat of AIDS, we will see a rush to the term market by those who perceive themselves at risk. Underwriting standards are already becoming more strict. Companies, including ours, are lowering the limit for the human immunodeficiency virus (HIV) test. Some companies are considering an AIDS exclusion. However, any underwriting alternatives may be limited by various state laws and regulations.

We've done projections similar to those in Michael Cowell's report did and got similar results. I believe this will lead to more use of non-guaranteed elements in product design to price competitively yet allow for future deterioration in mortality experience. Eventually premiums will have to rise or dividends will have to fall to cover the cost of AIDS claims.

MR. TILLER: Does anybody else have any ideas on how to deal with the term insurance aspects of AIDS? I think conversions could be a special problem. The "last chance" conversion has typically shown bad mortality. If you combine that with an AIDS scenario, the logical thing is for somebody to carry the term insurance until the last point and then convert. Hence, we have seen some companies starting to shorten the conversion period. If you have a conversion period that ends five years before the term period, you probably have eliminated the high risks -- and maybe all the risks -- of conversion with respect to AIDS. If they die after that five years, they are not going to know about it. If they die within the five years, you are stuck with them on the term plan anyway. Maybe a shortened term period, nonrenewable, reexamination product would reduce conversion risks regarding the AIDS risk on the term side.

MR. JOHN M. BRAGG: As some of you know, we're building up a large data base in our little consulting firm particularly on smoker and nonsmoker mortality. We have by now over seven million policy years of exposure. We are also asking the companies to report AIDS claims. We're very anxious to try to track the impact of AIDS. Through 1985 about 1/3 of 1% of the claims were AIDS. For 1986 it was around 1%. It may be a little higher now, but we don't have any tremendous panic on our hands.

Let me tell you a bit about some of these claims. The last bunch we looked at had 170 AIDS claims. I was anxious to find out how many of these are sensitive AIDS claims. An individual life or health policy is sensitive if it was applied for after November 1983 and the policyholder died of AIDS, i.e., the anti-selection bunch. Of the 170, there were 22 sensitive cases. This is the first surprise, that so many of them were non-sensitive. In other words they were coming out of old business. Of the 22, I was then very interested in seeing whether the defenses were any good. They seemed to be pretty fair. I'm talking about contestability, rescission, denial, and so on. I can't remember exactly how many of the 22 were defended against in that way. Obviously, it has to be in the first 2 years. It appeared to me that the defenses are pretty good, so what with the lower testing limits and with these defenses after the policies are on the books, maybe we're doing a good job of controlling it.

MR. TILLER: Unfortunately, a few other studies have shown there was anti-selection before 1983.

MR. MARK HOSKINS: I know a little bit more about AIDS than I do about term. We did some studies on 1986 claims. We had about 1,400 life insurance claims and we were looking at the anti-selection by amount. We too were surprised at the number of older policies. We had an AIDS claim with a policy duration of 45 which was issued at birth. However, they tended to be at very low amounts, averaging under $10,000. Another thing we saw was the anti-selection by face amount. Around 70-75% of the claims occurred in the first three years and were issued from 1983 to 1986, whereas that only represented something in the range of 20-25% by numbers. There were quite a few of them issued at birth and persisted into the 40s. I think 47 was the highest one we saw. We felt that there was quite a bit of what Jack termed sensitivity. We were calling it awareness -- an awareness, from the applicant's point of view, of a disease they saw their friends dying of, and they thought it was a good time to get some insurance. They became aware of a disease even before the insurance companies did. They had a 3-4 year head start.

MR. TILLER: Your study didn't differentiate between term and permanent?

MR. HOSKINS: At that time we were just trying to get the data done. What we did was to concentrate by year of issue. These were paid claims only. We had information that was submitted on claims that were denied or still in process. We were only looking at the paid claims just to get a fair representation of the amounts. These were the ones that weren't denied under contestability. That was to us a market anti-selection which was much more than the underlying growth in new issues during the time period. We have to recognize that older policies that were issued 30 years ago weren't for $100,000.

The other comment was on re-entry and what I see is an anti-select and ultimate table. After you have been through this extra mortality maybe the ultimate after a while is not that bad. AIDS has a long latency period so you can't rule it out. But a lot of it moves fast, especially among people who think they might be at higher risk than among those who are newly infected and are not quite aware of it.

On the re-entry, could there be the possibility of further blood tests as sort of a rechecking as you go along?

MR. TILLER: I think that with re-entry you can set whatever standards you want. You are basically issuing a new policy.

MR. HOSKINS: But is the re-entry underwriting rule as strict as the initial underwriting?

MR. TILLER: It can be as strict as you want it to be. For example, you can make the re-entry qualifications strictly a blood test. I think you can do it as long as you apply it across the board. However, your home state might challenge qualification by blood test.

MR. HOSKINS: So far we are a little bit ahead of that. We have an injunction against it.

MR. TILLER: I didn't say they would prohibit it. I said they might challenge it.

MR. HOSKINS: Testing now is a cost-effective method. It is cost-effective on a whole life where you assume they are going to keep it in force until they die. There is very little lapse, and the present value is about $500 per $1,000 of face amount. On term insurance, if you make it through one year, the chances of dying in the next year may not be as big, but as you go along you may have to worry about that more.

OPEN FORUM

MR. TILLER: Maybe the eventual product we need here is a five year deferred term.

MR. HOSKINS: Regarding the AIDS exclusion rider, that is one of the most dangerous ideas to come out of the AIDS crisis. I'm very much against it. Since it was brought up, I would like to get my two cents worth in to say that this is something that needs to be avoided at all costs. An exclusion rider is suppose to exclude some well-defined event. It has a low probability of happening but will significantly raise the underlying mortality. This is not the case for AIDS. There is a high probability of death during the term of the exclusion rider, and AIDS itself is not well defined. The definition is changing and you can't get two doctors to agree on it. We have trouble agreeing now just on the AIDS claims for study purposes. Imagine if the definition of it involved $100,000! It would be lawyers' paradise. Every attempt to exercise an AIDS exclusion rider to exclude a claim would result in litigation and damage to the insurance industry. It is very dangerous for people to think an exclusion rider could be a solution.

MR. TILLER:

REINSURANCE -- FRIEND OR FOE?

In a prior life I had the privilege -- or the punishment -- of being a reinsurance-type person. I used to have to sit up here answering questions about what are you reinsurers doing to ruin the industry. It was probably a joint effort; I think direct writers and reinsurers did this together. I don't recall any reinsurer putting a gun to anybody's head and saying write these term policies and give them to us so we will both go bankrupt. Many people did blame the term wars on the reinsurers' aggressiveness. I guarantee you the reinsurers were trying just as hard as anybody else to make a buck out of this and some of them did. We still hear some of those comments today. Most companies can't write large policies without a significant reinsurance commitment.

What is the current view? Is reinsurance a friend or a foe? We have a number of large companies that have special reinsurance arrangements of reduced retention or 100% quota share agreements or whatever New York will allow as a minimum retention. It is my privilege and great thrill not to have to answer these concerns myself and turn this over to Ray.

MR. BIERSCHBACH: When reinsurers were giving healthy first year allowances to the client companies with select and ultimate term products, they were viewed as friends. When they compounded that by giving overly generous ratings on facultative cases, the friendship became even closer. However, when reinsurers woke up to the fact that individuals were moving from company A to company B to company C and the same reinsurer was paying first year allowances for several years and then paying a claim down the road, they decided they had had about as much of that fun as they could afford and started to back off. In the eyes of the client company, they were then viewed as foes because they had led them into this trap and there was no way out of it. It was a two way street. The reinsurers were doing it to get market shares. The direct writing companies were doing it to compete with some of the markets they had not been able to get into. I'm hopeful that most of those incidents are now behind us.

Our direct side feels very strongly that they've got to work with their reinsurers on a mutually profitable basis. They realize that the reinsurer is entitled to a profit and wish to structure their reinsurance arrangements in a fair manner and one in which they could never be accused of "using the reinsurer."

As a reinsurer, we hope our clients feel the same way towards us. We certainly want to work with client companies in developing term products that are profitable to them and reinsurable by us on a sound basis.

MR. PETERSON: My company reinsures 90% of our term product. The motivation was to defend incursions into our market. We really had no idea why reinsurers were aggressive. They were willing to cover the cost of mortality at a lower cost than many direct writers could. We can only speculate that perhaps they were in a better tax position. Certainly, the competitive atmosphere in the reinsurance market had a lot to do with it. In my company's case, the reinsurers were willing to project future improvements in mortality experience where, as a mutual company, we could only illustrate current experience. We are happy to enter into the agreement and I understand that our reinsurers are also happy.

Our coinsurance allowances are probably not as high as they could have been. We had insisted on recapturing the business upon conversions, and from the reinsurers' point of view, a conversion was as bad as a lapse. On the other hand, we did not want to administer the reinsurance program for permanent policies. Both we and the reinsurers are comfortable with the current arrangement.

Reinsurance is now a way to of spread the AIDS risk throughout the industry. It remains to be seen, but I presume the reinsurers will choose to participate. They have the opportunity to provide guidelines to the direct writers for sound underwriting discipline. On the other hand, I don't expect the reinsurers to agree on the cost of future AIDS claims. And it's possible, though unlikely, that the reinsurer's differing views could precipitate a new price war. What is more plausible is that there will be a cooperative effort between reinsurers and direct writers to deal with a common threat.

MR. JOHN H. BUCHANAN: With respect to the reinsurers and the AIDS risk, I have a feeling that a lot of insurers are standing around the swimming pool. We all have our swimming suits on but we know that the water is cold and a lot of us are fearful of sticking our foot in the water. No one wants to go in because if we are the first ones to lower our testing limits, our marketing guys will tell us people don't want to have blood taken out. There is a real reluctance in this area. I talked with the reinsurers and they say a lot of companies are considering it, but when I ask them to give me names of companies who made significant reductions, they are very few. Perhaps our reinsurers can lead us in this respect. Some of them have made suggestions or recommendations, but there is a lot of exposure here. Sometimes the reinsurers get blamed for a lot. Perhaps if they take a firmer stand on testing limits they could be a friend again.

MR. PILGRIM: The reinsurers have taken a lead position with regards to moving testing limits down. Ray Bierschbach made reference to that with Transamerica Occidental. We and a number of our competitors have made a stand in terms of setting limits, types of evidence we need to underwrite facultative business, and amounts and types of automatic business that we will accept. I think in this case we helped our customers reduce some of the pressure they would get from their field force by saying "Look! We think this is the responsible thing to do and we think we ought to move in that direction."

One sidelight with regards to the AIDS risks and term insurance: We have a number of agreements involving guaranteed issue and simplified issue-type programs for fairly small amounts on a payroll deduction basis. As you might expect, we get a greater percentage of AIDS type claims under those coverages than we do under regular issues. Here is an area where we might be subjecting ourselves to greater exposure than we would really like. This is a tough area to handle for companies writing term insurance on an individual market -- trying to simplify the underwriting practices for expediency but running a much greater risk than they anticipated.

MR. TILLER: Another area I have heard a lot of talk about but have no statistics on is the credit insurance marketplace and the AIDS risk. I guess that is basically a term issue. I know one of the larger reinsurers has announced formally or informally to a number of clients that it is now enforcing a $100,000 limit on blood testing for reinsured cases and by June it will be down to $50,000. Does anybody have any comments?

MR. BIERSCHBACH: When we insisted that limits had to come down for facultative cases, we did not get a great hue and cry in our position.

MR. TILLER: At Tillinghast, we surveyed 23 of the larger companies. I believe 20 of them have lowered limits in the past 6 to 12 months. One said they were going to, but wouldn't comment beyond that. Another said they had an internal injunction against making comments because they had been quoted by the press recently and didn't want to be quoted again. Another had just moved offices and could not find their files. One would not disclose the limits because he was embarrassed by how high they are. If that gives you any indication, there is definitely a trend in that direction.

Earlier this year, I attended a workshop on reinsurance; one of the topics was AIDS limits. All the reinsurers share the same concerns are you. Many companies were reluctant to be the first to lower limits. They were looking for assistance. This is an area where the reinsurers can be a controlling mechanism and a leader of assistance to the direct writing companies because of broader experience.

OPEN FORUM

MR. PILGRIM: One comment, John, relative to not disclosing limits. There was a very interesting article in the *Hartford Times* about three months ago. They were trying to poll the companies as to what their blood testing limits were, and interestingly enough the companies did not want to disclose those limits since that would subject them to possible applications at or below the threshold limit. I think that is indicative of a change in our industry. Before, when a *Hartford* reporter would poll the insurance industry in Hartford, the companies felt free to give information of this nature.

In this particular situation they recognized the problem and they said "Yes, we changed our testing limits but we're not going to tell you what they are."

MR. TILLER:

PRODUCT DESIGN ALTERNATIVES

How can we position ourselves by 1990 or even this year to have a viable term product? I would like to encourage you to share some design ideas and concepts. I am not asking that you give away any innovative secrets or bare your soul about what your company is doing or how it is going to corner the marketplace and take away these guys' business, but certainly we can share ideas.

MR. BIERSCHBACH: On the reinsurance side, while we still see companies developing select and ultimate products, the frequency has slowed and we see more products of an alternate design.

We don't know yet what products will emerge, and it's generally conceded that there will be a lot of trial and error. The possibilities include:

1. Aggregate priced annual renewable term, perhaps for some limited period of time such as 20 years and a shorter conversion period.

2. Five-year convertible and renewable term or some other such product, thus returning to our beginnings.

3. A form of select and ultimate term but with the full degree of select mortality not being immediately reflected in the premiums so the increase is not all that great and you don't have the problem of re-entry being strongly encouraged by large increases in premium.

4. Some combination of products which gradually moves the insured from a low premium product to a slightly higher premium term product to a low premium universal life product to a full savings type product.

It appears likely that some sort of levelized commission will emerge. Perhaps it will start with the first three years' commissions being the average of the current high first-year and the two lower renewals. Maybe the period of averaging will be extended. Some companies have tried that and have not been successful. They might try it again in a different form and make it work. If we can make it work, we should be able to assume better mortality and lower lapses.

MR. PETERSON: There will be a need for flexibility in term pricing structures in light of the unpredictable future claims experience. More companies will rely on indeterminate premium and participating designs. And the guaranteed premiums in these designs are likely to increase. In this way, companies can illustrate competitively while hedging their bets on future AIDS claims.

Persistency on term plans has been a problem throughout the industry. A principle of sound product design is that either the policyowner or the agent should have an incentive to keep the policy in force. You can satisfy the policyowner by providing better value in renewal years than a replacement would. Or, if you make the difference between the remaining renewal commissions and the commissions on a replacement small enough, an agent will feel his time is better rewarded by prospecting for new sales. Ray has already given some examples of product designs consistent with this principle. A personal favorite of mine is the traditional participating design where premiums and dividends vary by both issue age and duration and the dividends more than negate the relative increase in renewal premiums.

Level commissions are consistent with this principle. Level premium renewable term plans are, too. Deposit term certainly is.

Now I realize that this principle runs counter to the desires of the field and of the marketplace. But you can violate this principle. However, if you do, you should manage the product carefully.

You can underwrite for persistency through the use of persistency raters. Some companies have attempted to charge the first two or three annual premiums in advance. A method of managing the agents is to charge back all or part of the first year commission on early lapses.

By 1990 we should begin to see a shake-out as to which of these designs and techniques work and which do not.

MR. HINKLE: One of the things that was mentioned earlier when we were talking about experience trends was that the band differentials were showing greater variations in mortality then had been originally expected. However, when we talked about the plans for the future in terms of premium design, I didn't hear anybody address that. Does anybody have any ideas about whether some of the banding that we have seen for the extremely large amounts may disappear, or ideas on how to keep the large amounts more in line?

MR. BIERSCHBACH: If the actuaries have to build that higher mortality into the bands, the amount differentials are bound to come down a little.

MR. TILLER: I felt for a number of years that we, as an industry, have been deluding ourselves on the differential. I don't think there is that much expense savings with the large policies. I believe most studies will show that the larger policies are much more susceptible to higher lapsation. A corollary of that should be more anti-selection on renewal. While you may get a little better first or second year mortality on a large policy, the renewal mortality deteriorates faster than in the smaller policies. In addition, large policies have shown more first or second year duration anti-selection from accidents, suicides, and suspect deaths, such as disappearing in the Gulf, for $10 million. If you put the whole thing together, you might get better medical mortality but worse overall mortality. I fail to see why there should be much differential.

MR. HINKLE: Do you expect the problem to be addressed in product design or in different underwriting approaches?

MR. TILLER: Frankly, I expect the problem to be ignored. The problem has been there for five years and it has been ignored. I don't know anybody who has come up with an intelligent idea on this. Perhaps this is an area where the reinsurers will come into play with the type of pricing that they offer. Ultimately the large policies are supported by the reinsurers. If you have a company with a $100,000 retention and $500,000 or million dollar bands, you know that is a reinsurance issue and a reinsurance negotiation issue. As long as the company can pass along the lower price because of favorable reinsurance terms, they are going to pass it along. They are going to satisfy their agents.

MR. BUCHANAN: We're coming out with a new term product that is replacing our select and ultimate product. It is an aggregate attained age product. We are running into some interesting issues in the product design and the pricing as we look at this band question. You have to make a decision as to whether you are going to spread your AIDS risk across all your bands even though you are going to be testing at the higher limits, and your mortality assumptions have to be very well tied to your testing limits. We have found, for example, that if we move our testing limits down to $100,000, our assumptions for the anti-selection in the nontesting area put a tremendous load on the mortality risk and the mortality assumption. We will have to pay close attention to this as we price and design these products. If the bands are not in synch, we will have a real load-up in the non-medical, non-tested area.

MR. TILLER: That's a very valid point.

MS. PATRICIA L. SHAPIRO: With regard to AIDS, it occurs to me that perhaps lowering the testing limits to, say, $100,000 isn't going to reduce the AIDS claim in the industry because the AIDS group is pretty sophisticated and there are a lot of AIDS support groups. Instead of getting one $100,000 policy, they will get two $50,000 policies, but the amount of AIDS claims would be the same as before. It also occurs to me, after looking at a number of medical histories of AIDS patients, that it is fairly easy to look non-medically or to look through attending physicians' statements and determine who is at high risk for AIDS, without requiring the AIDS test.

MR. TILLER: You do have certain regulatory issues regarding discrimination that can cause a lot of trouble. But you brought up a point about the support groups. There are legends adrift about AIDS support groups that give the latest non-medical limits and where to go to this week for insurance. We have not found any evidence of that. What has been found is that the industry itself through its normal competitive practices promotes this type of thing. I'm sure that most of you have seen a flyer from an agent promoting this week's best substandard shopping program. I don't mean reinsurance, but the substandard specialist who says, "Give me your problem cases and I'll take care of them." There is evidence that there are a few of these working in the District of Columbia, and they will place the cases. I don't know if this is so much a problem because of the high risk AIDS group as because of agents specializing in their substandard marketplace.

MR. DOUGLAS S. VAN DAM: Have you seen any evidence that people are having minimums on their term policies that would exceed the blood test limit? In other words, if you have a $100,000 limit for a person with a positive blood test, is that where you start your term policy?

MR. PETERSON: We're having a debate about what the appropriate limits are. We are very fearful of anti-selection, especially on term insurance. The debate right now is whether to lower the testing limit down to the term minimum or to raise the term minimum up to the testing limit.

MR. TILLER: It is pretty hard to justify a $10,000 term policy. Since a number of my clients are looking at a $45 to $50 policy fee, there might be a natural movement in that direction.

MR. BUCHANAN: We wrestle with that question with our agencies. Our current minimum on select and ultimate is $100,000, but there is a price to pay: the premium cost has to reflect the exposure for that band.

MR. TILLER: We talked earlier about banding. When you look at the difference between a $50,000 and a $100,000 policy, the difference in mortality and the difference in testing, you can see some significant drops at the point that you put in testing. My comments earlier on banding really apply to the million dollar bands. Is that worthwhile?

MS. NEENAN: Moving from AIDS to another favorite topic, the tax law: We don't know what is going to happen, but we have to anticipate that some time before 1990 there will be some kind of tax on distribution or restriction on inside build-up. I think we are going to be looking more at some combination or hybrid-type products that have some of the favorite features of permanent, for example, vanishing premium, and incorporating that in the term design. We have always looked at term and permanent as totally different products, and it is hard to explain to an agent why, if he lapses a term policy and has the person provide full evidence for a new permanent policy, that is a bad replacement, but if he lapses a term policy and converts it to permanent, that is a wonderful event to be celebrated. When agents ask why, we say that is the way we price the product and you have to live with it. I think that when you look at term and term-type universal life, it is hard to justify the bright line that we have drawn between term and permanent. I really see that as an issue that needs to be addressed in the next five years or so.

MR. TILLER: I think you are absolutely right. With the recent stock market events, some of you writing variable products may need to address the fact that you have a term product. Is there any follow-up on Alice's comments? I think there is a real gem of an idea there to help deal with the future marketplace and solve some of the long term expense problems.