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Session 43D
Preferred Risk Plans: Should We Have Three Classes or Six?

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Summary: Preferred products continue to evolve. The number of underwriting classes on a product may be two, eight, or anywhere in between. Among the multiple risk classes offered on a product, many of them are for "preferred" risks.

How many preferred risk classes are appropriate for today's products? Should you offer three, six, or some number of preferred risk classes? Does the number of risk classes appropriate for your product differ because of your market, the size of your company, or the culture of your company?

Does it really matter how many risk classes you offer? What are the pricing, underwriting, and marketing implications of the number of classes chosen and how well is the selection process for these classes implemented?

Four experts in the field, two underwriters and two actuaries, have a lively debate on these issues. Audience questions and views will be solicited by the moderator for the debaters to discuss.

Mr. Allen M. Klein: Welcome to the new Hawaiian game show The Preferred Feud. For those of you in the audience who are unfamiliar with the game, I'll

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explain works. First, we're going to take a vote to determine whether or not you feel that there should be three rate classes or six. What I mean by three rate classes is, one preferred nonsmoker, a standard nonsmoker, and a smoker. Six classes could mean all kinds of things. It could mean four nonsmoker classes split any way or five nonsmoker classes. The point of this is not three classes versus six classes; it is whether we should have more or fewer classes. That's really the issue here.

After we take a vote, our debaters will speak. The team that supports three classes will speak first, followed by the team that supports six classes. Each team will have 15 minutes to respond. After that, we'll take another vote to see whether you have changed your minds. After that, the teams will have a rebuttal, we'll take another vote, and then we'll open it up for questions.

Let me introduce our speakers. We have both an underwriter and an actuary on each team. On the "three" team is Jennifer Richards, who is a senior underwriting consultant at the Principal. Jennifer has developed the current preferred criteria for her company. David Rains is the director of business consulting with Security Life Reinsurance. He was formerly the director of product development, so he also knows quite a bit about preferred. Carl Macero is the vice president and chief reinsurance underwriter at Transamerica Reinsurance. He is currently responsible for his company's underwriting operations. Last, but certainly not least, is Jimmy Atkins. Jimmy is a senior vice president of fixed life products with GE Financial Assurance and he has done extensive work on First Colony's preferred products. So I think we have a good panel of experts here. Hopefully you'll learn quite a bit, and we'll have some fun. But first we must vote. All of you who think that we should have three preferred classes, please raise your hand. It looks like 59. How about six classes? That's 34 for six classes. How many aren't sure? Seven. Looks like the "six" team has their work cut out for them. All right, now were ready to get started. We'll see if they can persuade you to switch your vote. Is the "three" team ready?

Mr. David A. Rains: We're ready.

Mr. Klein: All right, go ahead.

Mr. Rains: Our review is not to tell you exactly how many classes to have, but to tell you that maybe it's worthwhile considering not dividing your risk pool into all the risk classes you can possibly think of. We've had a few innovations in risk division over the last several years. Way back, it's all aggregate rate—male, females together. We realized later that there were some pretty big differences in male and female rates, so we split that out. Finally somebody said, smoking is a risk factor and we had enough data to validate that conclusion. So, we have a long history of a very valid smoker, nonsmoker split.

The preferred split from the nonsmoker category was fairly recently compared to both and it makes a lot of sense to all of us.

What about a super preferred class? You can carry this out infinitely until everybody is in their own class. I think the idea is, where do you stop? We would suggest that we might stop sooner than our esteemed colleagues might suggest. One of the reasons that we'd want to talk about that would be maybe it's not good for the industry as a whole to have this many preferred classes. Jennifer will discuss the things it does to our underwriting process and the way it might be viewed by outside parties. I'm going to talk first about some reasons why it might not be the best thing for your particular company to have such a refined preferred structure.

Of course, I'm the actuary, so I'll talk about it a little bit from a mortality and pricing standpoint. Mortality is the biggest issue that we can consider. There are a couple of competing actuarial principles involved when you split your population into many classes. First of all, there's the principle of homogeneity: the more alike the people in a given class are, the more predictable the results are. That's very straightforward. That leans to having more and more classes.

But the other principle, one that I think has been recognized for a long time as the founding principle of insurance, is the law of large numbers. The more people you get who are alike, who are rated the same way, the more predictable the outcomes are and the tighter the standard deviation around those outcomes.

I think that we need to be careful about having such a small population in whichever class that we're talking about. Maybe the ultra super mega preferred's average expected mortality is very, very good, but our standard deviation and our variance of volatility is so large that terrible things could happen. How many mega preferreds can fit in a phone booth? Answer: both of them. There are just not that many out there. So that's the biggest issue.

I would like to ask whether we're that good. I kind of said that assuming that we're right, assuming that we are smart enough to classify everybody correctly and accurately every time. But what if we're not that smart? We're not going to know for many years if the decisions and the commitments that we're making for each of our companies today are accurate and on track and whether we're going to make money or lose money in the long run.

We can get good ideas, but remember, the higher the volatility, the less chance of our ideas being correct. And even if we are correct about maybe today's level, what about the slope? What about the curve of all of these selection criteria? How does that change over time. There are so many variables that maybe we should exercise

a little bit of caution before making our decision to oversegment the market. Of course, even if we are that smart, is everybody else that smart? Are all our partners in our companies who are working with us to accurately classify and measure all these risks as smart as we are? When we sat back and theoretically decided what was the best way to do it. Are they going to do it right the way that we told them to every time? And what is the effect on our bottom line if they don't?

In addition to the mortality, we have some other issues. Lapse is something that interests me. It hasn't been too much of a problem in recent years. I guess I can get concerned about it without much trouble.

Basically right now we have a situation where we're frequently low on prices. We are segmenting classes. There are classes that exist today with lower premiums than last year, and somebody who would qualify for that class now didn't qualify last year because the class didn't exist, so he or she is paying more. This year why wouldn't a prudent buyer with a good agent lapse the old policy and buy a new one? And once the buyer does that the first time, he or she realizes how neat that is. A buyer might look around next year to see whether this same situation exists and whether he or she could take advantage of it. We shouldn't be surprised if they do that because we're training them very carefully that that's what they ought to do. Maybe we shouldn't do that either.

From the expenses standpoint, it's expensive to stratify all these risks. We have to have more tests and more requirements. We have to begin to find new ways to differentiate one risk from another, and that involves getting more evidence, at least it usually does. That, of course, brings us to our underwriters. We're asking a lot of our underwriting staff to make those very, very fine differentiations between people, not only from the standpoint of looking at a broad range of data, which requires a lot of their time to review all of it, but also of having many points of argument with the field. The field may not get the class they want the first time. Probably all of you have encountered a client or an insured who's not getting the policies that he or she wanted. Go talk to your underwriters if you haven't because they'll be glad to tell you what a pain in the neck that can be. There will be exceptions made, that's just the way it's going to be. How are we going to handle that, and is it going to work out for the best in the long run? I promise it will add to our volatility and that's the biggest issue that I want to put forward. Jennifer also has more things to say about underwriting and how more classes come to meet that.

From a marketing and sales strategy point of view, is this right for your individual company? We're caught up in this cycle of finding ways to get people to pay us less for the services we do today. Maybe we can look at another strategy. Maybe we can find a way to not get paid less for those services and the coverage that were

providing right now. It's not the easiest thing to do. The easiest thing to do is lower our rates, split classes, cut costs, or whatever it takes, and get out there and sell it. But maybe there are some other strategies that are worth pursuing that ultimately will be more beneficial to all of us. Jennifer will talk about the same situation as it relates to the industry as a whole.

Ms. Jennifer K. Richards: I'd like to start by reading you a quote from the 1997 American Council of Life Insurance Map Survey, which is a study that monitors public attitudes about the insurance industry. In the study one of the quotes states, "Almost half of the public believe that the basic principle of charging people for life insurance according to their relative risk of dying is unfair. Companies are more interested in "cherry-picking" than in making insurance available to as many as possible." I think that statement should cause professionals in the insurance industry some pretty significant discomfort.

In the past, the insurance industry has been able to gain at least some public support for the risk selection process because we have been able to issue our best class to more than 90% more of the insured population. Today, with the multiple preferred classes, we're lucky if even 50% of our company's clients end up with our best class. I think that we end up with some very disgruntled clients who aren't qualifying for that best class. Wanting to be the best and pay the lowest price are natural human traits, but just by the nature of our risk selection process we're automatically upsetting half of the clients we work with.

Now every nonsuperhuman, nonsuper-preferred client will come away with a little more distrust of the insurance industry and standard rates will naturally be increased as the best of the super preferred and preferred risk are pulled from the standard pool. The industry is already under attack on numerous fronts. Legislators across the country have either passed or are attempting to pass laws that limit our ability to select risks. A majority of the American population feels that insurers should not have access to genetic information, and Congress has repeatedly looked to the inside build up of cash values as a pot of gold to help solve our budget woes.

The insurance industry is seen as an easy target because politicians are aware that the general public does not trust the life insurance industry and does not understand or support the risk selection process. We need to be constantly looking for ways to improve the public perception of our industry. Price wars in super-select, preferred classes may offer the glamour of short-term sales, but they also contribute to the long-term decline in the health of our industry and the continued degeneration of public opinion, especially among those individuals who don't qualify for our best classes.

We also need to consider the impact these price wars have on our field force and our underwriters. At our company, and most likely yours, we are expending a great deal of effort to try to foster a good working relationship between our underwriters and our producers. We feel underwriting adds value to the marketing process. Trying to place nonbest class policies only complicates our producers' lives and increases their distrust and animosity towards underwriters. And tighter distinctions between preferred risk classes only aggravate the situation. Have you ever tried to explain to someone why they can't have super preferred because their father had a heart attack at age 59? If their father only had the decency to live until age 60, then they could qualify and be a super preferred plus. The distinctions just aren't significant enough to be meaningful to our clients or to our producers. And, of course, it only complicates the confusion because company X will give that client super preferred class.

We train our agents to go shopping for the best rates. And what do they find when they're out shopping around for that best rate? There's a company that maybe has a more competitive compensation plan or products that are more appealing. How many producers have you lost because they found a company that's easier to do business with?

I think we need to challenge ourselves to ask the key question for risk selection professionals. Does it make sense that we can truly select risk with enough accuracy to meet the pricing assumptions of six or seven different preferred classes? Does it make sense that we engage in price wars that push our margins to the point where we are making very little profit, even if we are fortunate enough to hit our pricing assumptions? Does it make sense that we should institute pricing policies that contribute to an adversarial relationship between underwriters and producers? Finally, does it make sense that we should do anything that will ultimately contribute to further deterioration in the public's opinion of the life insurance industry?

Mr. Rains: I think what we're trying to say is that you can step back and you can theorize and you can put forward your best guesses, but there are some real and legitimate reasons why implementing those guesses may not be in the best interest of your company or of the life industry as a whole. We'll look forward to your comments after our colleagues have presented their side and we have our rebuttal.

Mr. Klein: Thank you "three" team. Now, let's listen to the "six" team.

Mr. Carl Macero: The main focus of our comments regarding the multi-preferred classes has to do with our competition. The competition that we're speaking about is the sometimes rather large or maybe not-so-large group of companies that we

have selected to be our main competitors. It is our position that all of these companies offering billions of dollars of insurance with multipreferred classes really know what they're doing. We believe that these companies, as well as ourselves, have the underwriting, actuarial, and medical expertise in order to create more than a single preferred class to service the needs of the marketplace. So to be competitive today, we need to choose who we're going to compete against. We need to choose our competition, and it is in that body of companies that we're targeting to be winners. We need to choose our own company's positioning within that competitive arena.

Mr. James D. Atkins: To decide how many preferred classes to offer, you have to answer five questions. Write these down. The first question is, Can you distinguish among so many classes? Second question, If yes, will a competitor do so? Third, if they do, do you have to follow suit? Fourth, are you in a competitive environment? And finally, can you administer a program with many multiple classes? With those five questions, let's begin. Carl, can you distinguish among so many classes?

Mr. Macero: First of all, we have to understand what was the precursor of preferred. The precursor truly was the smoker/nonsmoker classes that we had so many years ago. A smoker/nonsmoker was that attempt to attract the best and healthiest risks within that large standard category to convince our customers to buy our company's product by offering the best and healthiest risks, a very attractive product at a very attractive premium rate. Then from smoker/nonsmoker distinct products, we branched out to preferred classes, and the rest is history.

Mr. Atkins: Experience for my super preferred class measured mortality is 20% lower than on the regular preferred class. Is that enough to tell the difference between the two? Is it meaningful or is it not meaningful? I would propose that it is indeed meaningful.

Regarding question number one, our conclusion is you can distinguish between classes.

Mr. Macero: Well, if you can distinguish between classes, will a competitor do so?

Mr. Atkins: Well, if somebody can, somebody will. And what happens when they do? Consider a six-class company with four nonsmoker classes and a three-class company with preferred nonsmoker and smoker. If you look at prices between the six-class company and the three-class company, what you'll see is that the six-class company's rates bracket the three-class company's rates, so that the six-class company is always getting the best risks. There's the super preferred and the second level of preferred in the six-class company, versus the best rate for the three-

class company. Everywhere the three-class company has a rate, the six-class company has one above it and below it.

Let me tell you a story about one company that started off in the term marketplace from virtually nothing. In 1994, this company wrote $6 billion in face amount. In 1995, it wrote $34 billion in face amount. In 1996, it wrote $54 billion and $61 billion in 1997 in face amount. This is a company that has as many classes as anybody. I'll let you figure out who it is. But ranked by face amount, they went from 51st to eighth to second in 1996. This company with multiple classes is having big-time success. Another company that was into multiple classes had just four classes and their sales were doing well. They were up in the top ten ranking of companies. In 1996 they started to fade a little bit. In 1997, they introduced a super preferred class and bounced back up writing $47 billion in face amount. So the companies that are at the top of the list for sales are either the extremely big companies or are the companies that have multiple classes. That's where we think you ought to be.

The answer to the question, Will competitors do so?, is you already have competitors who are doing six-class underwriting.

Mr. Macero: If you are in that competitive environment, and I think we all believe and conclude that we are, must we then follow suit and do the same thing as our competitors?

Mr. Atkins: It depends on what you have to sell. If you're selling a product like whole life insurance or single premium life insurance where the risk is not so great, then perhaps having fine distinctions in the mortality rate is not so important. But if you're selling a product like term insurance where it's only mortality, then having these multiple classes becomes more important because that really delineates one company from the next. If your competitors are using multiple classes, you have to as well.

I want you to use your imagination now and think of two companies; company A and company B, both in the same environment. Those companies are selling business with just one nonsmoker and one smoker class, and they have an equal distribution of the markets. Now suppose company A goes with six preferred classes. They're going to do that bracketing of their competition. What's going to happen is the market is going to shift. If there's any fluidity at all in the market, business will move toward the lower price. The ones that can qualify will. Company A with the multiple classes will get an increase in proportion of their best rate and decrease in their worst rates. Company B will stay the same, will have the cream of its crop pulled off and they're going to be left with the dregs. Their

average mortality will go up. They will experience more claims than they priced for because the body of lives that they have in their group are worse than they had before.

Mr. Macero: Let's look at the realities of our current marketplace today. If we offer but a single preferred class, and let's say we set the qualification percentage for that class to attract the best risks, the percentage who qualify will be small. Then the competition—here's the important point—that body of companies that we want to compete against, the competition with multiple preferred classes will get the best of our residual standards. We can't win enough business in that single preferred class. With just one preferred class, the differential between preferred and standard premium rates can be rather large, especially if that single preferred class is priced competitively. In that scenario, the number of not takens for us can easily increase dramatically. So competition requires that we use multiple preferred classes to increase our chances of attracting the very best risks. Multiple preferreds are a defensive and offensive position all rolled into one, because we have to remember that otherwise we will not get the best risks ourselves. But if we have multiple preferred classes, remember that we, the underwriters, are the ones picking those best risks.

So in the competitive environment must we follow suit? Our answer is certainly yes. If we don't match the competition, our mortality margin will begin to shrink. Can we afford to do that? Absolutely not; therefore, we must follow suit. Ask yourselves, are you in a competitive environment today?

Mr. Atkins: I think the answer is clearly that you are. Multiclass companies have been very successful. There are reinsurers in this room who will be happy to put you into multiple class underwriting, if you want to get there. It's still true that life insurance is sold and not bought. I'm sure you've all seen advertisements on television or heard it on the radio or seen it in print. We've got a copy of today's *Wall Street Journal*. On page two there's a tiny ad for term life insurance. The last time I looked in *USA Today* for articles, I was fortunate to find this giant-sized one, which says, "Don't you understand? What part of the term price war don't you understand?" For buyers of life insurance, rate information of life insurance is all over the Internet. There are numerous Web sites available. On Quotesmith, if you don't have a super preferred class, you don't even show up on the first two. So if anybody's out looking, if anybody's out shopping and you're not in this multiple class environment, you're not going to come close to competing.

As an insurance professional you have to ask yourself, what would you do if you were going to buy life insurance? Would you look for the best price? Are you willing to pay 50% more just because it's easy? The answer to that question is no.

You have to ask yourself, if your neighbor down the street is willing to just buy the first thing that comes along? Or is he or she willing to pay attention to Select Quote television ad and Matrix Direct on the radio and anything else they hear about from their neighbors or find on the Internet? I think the answer is you are in a competitive environment and it's rapidly becoming more so. We can do multiple classes. Competitors have already done so and we have to follow suit because we are in a competitive environment.

Because we should, the question becomes now, how do we implement such a program?

Mr. Macero: Once again, competition drives us to have multiple preferred classes. It is our responsibility as underwriting professionals to manage limitations and complexities that preferred risk underwriting presents. It is our position that the underwriting professional can distinguish between those two or three or maybe even four preferred classes. As an underwriter, multiple preferred classes may mean more discussions as to which class a particular risk may fall into. But remember with more classes, the differential in premium rates is less between classes, which increases the underwriter's flexibility within reasonable parameters.

Mr. Atkins: So because other companies are doing it, you have to find a way.

Mr. Klein: Thank you "six" team. We're going to give them a minute or two to prepare their rebuttal comments. While we do that, let's take a revote. How many now want three who didn't want three before? How many want six who wanted something else before? How many are now undecided who weren't before? So we have 11 more that are on the "six" team's side, four more who are now undecided. We're going to have questions after the rebuttal.

From the Floor: This pertains to the vote. Are you asking what's appropriate or what we should do?

Mr. Klein: I am asking what you feel you should do. Let me also see where these numbers came from because I think that's interesting too. How many changed their vote from a three? How many changed their vote from a six? How many changed it from undecided? All right, now I'll see if I can do the math here. Game show hosts aren't usually good at math. This is looking quite close now. We have 47 for the "three" team, 45 for the "six" team, and 9 undecided. So the undecided can be the swing vote here. Wait, this doesn't add up. We'll get it right the next time.

For the rebuttals, the "six" team will go first, and then the "three" team will wrap it up. Each team has 10 minutes to rebut. The "six" team will go next.

Mr. Atkins: Let me start, Carl, by responding directly to the point that David and Jennifer raised. First, David said we really don't have enough data to do it. But we do have enough data to do smoker/nonsmoker. I would submit that you go back to the beginning when State Mutual was the first to go smoker/nonsmoker. It didn't have much experience data. It had general data from the government's health statistics or something like that, but they didn't have insured life mortality data. But they did it and everybody else has done it now. So I think the not-a-lot-of-data argument doesn't hold much water. He also mentioned that fewer classes would give you a smaller variance. Well, you and I know that mortality has a spectrum. You have people who are very healthy, very long-lived, and some who are not going to live very long at all. There's also a spectrum in between. It's not a quantum point. So a multiple class environment gives you a closer fit to that continuous line of mortality than just a few classes would. I don't think the variance argument holds up either.

Finally, are we smart enough to know the difference? We think we are. That's why we're doing all this stuff. We really do think that our medical knowledge, underwriting knowledge, and the measurements we are able to do show that we are smart enough to do this. As David said, when you have a multiple class environment, there is more opportunity to buy cheaper policies. But I would submit to you that the companies with just a few classes will find many lapses and the companies with many classes will find many sales.

Is it expensive to stratify the market into all these classes? The data we use are essentially the same data that a three-class company would use. We get the same blood tests, the same urine tests, a paramedic exam, and medical history—we just use those data differently. So we're not spending a lot more money doing more or fancy tests. We're using the exact same tests, the exact same data, and we're just splitting that data differently. So there's no extra hard dollar expense involved.

Is it difficult to underwrite? Yes, it is difficult to underwrite because there are many more underwriting decision points to make. It requires a little bit of extra work in managing agent relations. You have to make sure that everybody knows what's going to happen and what to expect, and we must have a plan to deal with it. It is difficult, but doable.

Finally, do we want to get paid less for this? No, we don't want to get paid less, but maybe we want to get paid less per insured life and have a much lower risk of paying a claim. The goal is to increase the total revenues and decrease the total claims or to increase the difference, i.e., our profit margin in dollars. The claim rate and the price per 1,000 is definitely coming down, but the percentage difference, and the total dollars of profit is going up.

Jennifer mentioned an item about disappointed clients. It is tough and it requires managing the expectations of the clients. So if you tell everybody that comes along, "You are going to be super preferred. We're going to get you a dirt cheap rate," then you're going to have many disappointed clients. It's important that you manage the sales process so that each applicant has a reasonable expectation of what they might get and therefore are not very disappointed if he or she doesn't qualify for super preferred.

Are the margins small? The best margins are on the super preferred class. The worst margins are on those residual classes where there's somebody else with a better rate. If you're only a three-class company, you only have residual classes.

Mr. Macero: I want to spend a little more time on the point where a statement was made by our opposition that more tests are required for the super preferreds and preferred elite classes. I construct many of these preferred criteria for my customers all the time and that simply is not the case. I would say in the far, far majority of instances, as Jimmy had said, we use the same basic information of the lowest priced preferred versus the most competitive preferred class. So that really should not be an expense issue. You are spending your acquisition dollars on the same basic information.

As far as it being a tougher situation for underwriters having multiple preferreds, we made the point that if you have multiple preferreds, the price differential between the classes is less. To me, that gives us, within reasonable parameters, a certain amount of flexibility that we don't have if we only have a single preferred, especially if that single preferred is a competitive preferred that qualifies only 40% of our standard risks. So I think having multiple preferreds gives the underwriter a little more flexibility. Yes it is tougher, but it is well within our underwriting expertise.

I'd also like to spend just a little time on the quotes that we all came up with, and make some brief rebuttal comments on them. Jennifer used the American Council of Life Insurance quote to start off her comments. But I see this quote as more of a criticism, not of preferred risk underwriting, but of the entire risk selection process itself. As a matter of fact, when you fold in the overall risk selection process—this applies to whether or not you have a single preferred or many, many preferreds—our position on this is that we have to do a better job educating the insurance-buying public and our agents on how to position these multiple preferred classes. A comment that some of us may make is that we have heard that argument so many times, and it has not been a successful effort on our parts. But I'm saying the winners going into the next century will be the companies that have figured out a way to bring that message across loud and clear.

We don't disagree with the very first quote, the quote from *On the Risk*, which is saying basically that it's really very, very difficult, if at all possible, to differentiate between extremely refined preferred classes. There comes a point where you can slice and dice to an extreme point, where it is going to be very difficult to differentiate between classes. But in the classes that we're talking about, the three and four preferreds we believe through underwriting expertise that we will be able to make that distinction. We agree that if there are too many preferreds, we cannot distinguish properly and price properly. With the number of preferreds that we're talking about, we believe that we can do that most effectively.

When you analyze the other two quotes, our side believes that you can see a lot of sense in them. For example, regarding that first quote, wouldn't you say that the minimum number of preferred classes have to be at least equal to the number of classes offered by the majority of your primary competitors? Once again, we're talking about those competitors who assess, who know what they are doing and can design preferred programs with proper profit margins built into them. If we disregard what our respected competitors are doing, and elect not to compete in that marketplace, then I think that you can look at the last quote and see that those companies who make that choice will be the losers as we go forward. The companies that are offering the multiple preferreds basically will have constructed a paradigm shift against us. They will be over here operating in a very lucrative marketplace and we will be left behind.

Mr. Klein: Thank you "six" team. "Three" team are you ready for your rebuttal?

Ms. Richards: Yes we are.

Mr. Atkins: All right, go ahead.

Ms. Richards: One of the questions that Carl and Jimmy raised is, can you distinguish between multiple classes? David, do you want to respond to that one?

Mr. Rains: Absolutely yes, we can tell the difference. I wouldn't question that for a minute. Jimmy also mentioned that when we, as an industry, did the first smoker/nonsmoker split many years ago. We didn't really have the data to do it, but everybody assumed it was there and they knew well enough. They did it and now everybody has done it. I think that goes with what I had said before: maybe we don't have enough data for the kind of splits that we're talking about now. I guess my response is still the same. When you talk about the difference in smoker/nonsmoker, you're talking about a mortality difference of at least twice that many ages as compared to differentiating between five and six or six and seven or

seven and eight preferred classes. You're looking at much, much smaller differences based not on a gross, very large, single risk factor, but on several risk factors. Although we can tell the difference, I'm not sure that we can tell what it will be ten years from now, and I'm sure that's affecting our pricing. I'm not sure that we pay attention when we're pricing as to how much variation off of that we can possibly have.

As Jimmy indicated, we reinsurers do price at those levels. There's not much margin though when we price at a particular mortality number. If you look at the sensitivity of the mortality to our pricing results, I think you'll find that it's very sensitive. You can have a swing that's very insignificant from a broad perspective and that class is not going to make you any money at all. So I agree. I would question the extent to which it's useful or that we can count on it or whether it is prudent for us to use that in our pricing.

Ms. Richards: I also think you have to consider that although we can price the risk accurately, do we really know that the underwriting criteria that we are using to select those risks will truly result in the mortality that the actuary has priced for? Personally, I question that. I developed our underwriting criteria that we are using to select our preferred class. There are a multitude of different criteria, and there is a synergy of those different factors. I don't think that anybody really knows that they will truly predict the mortality that we are looking for. How do you really know that a cholesterol of 5.0 is going to produce significantly better mortality than a cholesterol of 5.5? We also have to consider that much of our criteria are designed to select cardiovascular risks. We really have not established or found criteria for accurately predicting cancer risk, and I think as we move into the future we need to look for those types of criteria. What impact will that have on our companies long term as our clientele that have been put into these preferred classes ages?

We also need to strongly consider the number of exceptions that are being made. We talked a little bit about the difficulty between underwriters and agents and brokers when they get into discussions over why isn't my client preferred? Why isn't my client super preferred? Those agents and brokers can put a lot of pressure on your underwriters and there are many exceptions being made. I know from talking to reinsurance companies that they are auditing many direct writers because there is so much concern over the number of exceptions being made. So when you add it all up, are the criteria accurate? Will it produce preferred or super preferred mortality results? Are underwriters really able to enforce and administer that criteria, even if they are accurate? I think it's leading up to a lot of uncertainty and we may be bringing excess risk to our companies 10 or 15 years down the road.

Another question that our opponents brought up is, must we have multiple preferred classes if our competitors do? My mother used to ask me, "If your friends were going to jump off a cliff, would you jump too?" I think we've seen the results of companies engaging in excessive competition and overly aggressive underwriting in the 1980s. Many companies suffered huge losses. I think the key point is, it's not necessarily wise to always follow what your competitors are doing. Should you follow your competitors to your company's peril and doom or do what really is in your company's best interest? Selling lots of business that is underpriced isn't good for anyone's business. Our job is to ensure our company's future profitability, not that we're getting the most sales today.

Mr. Rains: Should you do what your competitors are doing? That's a very valid point, and it's a very strong force in the decisions we make to be a viable company from day to day, from product to product, and from strategy to strategy. However, not all distribution channels, not all products types are as sensitive to that issue, to that price point as others. Examine it from your own company's perspective, is your distribution channel going to respond only to price, or also to service, to innovation, to new creative products? Maybe in the price game, the only winning move is not to play. By that I don't mean not to play at all, but to pick your battles more carefully. Perhaps your competitors ran out there and did that, but maybe those aren't your competitors anymore.

Look around, examine where you really want to be, what you want to do for your company, and go there. Saying, "I want to do what my competitors do," means you are assuming that you have the same strategy today that you did yesterday. Be more flexible, and be ready to find the right places in the market and the opportunities where you can make the most return for the effort that you expend.

One other issue we talked about goes somewhat with the selection and with the kind of money that we're talking about pulling in. Jimmy mentioned some examples where companies have used multiple classes to their great advantage. Those companies were selling in the $40 billion range, and now they are selling in the $60-plus billion range. In fact, even when they weren't doing very much, I think sales were at $6 billion, which is still a fair amount of insurance. If you're selling well in excess of that, then maybe you do have enough business to make these kind of judgements, and maybe you do have enough business to take these kinds of risks. I would suggest that there are many out there that don't have portfolios that large. They aren't bringing that in every year and they need to be more prudent.

Ms. Richards: Another one of the arguments or suggestions that Carl made was that we need to train our field force to sell standard to its clients and then to surprise the

clients if they get preferred. The field force must make sure that the clients are prepared and understand the risk selection process. I'd like a show of hands. How many of you have tried to work with your field force—either you, your underwriters, your administrative staff, or distribution team—to help them to understand that they need to sell standard and then surprise the client if they get preferred and to educate their clients? Almost all of you. How many of you actually have been successful at that? Almost nobody. In theory it sounds really good that we can train our field force to sell standard and then surprise the clients with preferred. In reality, it just doesn't work. We have tried that numerous times, and when the field force is spreadsheeting and working against the competition, the field force will always show the lowest possible price. Although it's good in theory, from a realistic standpoint it just doesn't work.

They're also questioning our assertion that it costs more to underwrite preferred. I maintain that if you have multiple preferred classes, it costs more to underwrite. We're getting a lot of blood profiles but as companies look at stratifying their risk more tightly, they are adding additional tests. They're adding a Hepatitis B and C screen; they're adding microalbuminuria tests; they're adding alcohol markers because they need to find some way to differentiate between risks; and, you can only slice cholesterol so far. It reaches a point where going with a lower cholesterol just won't produce the mortality results that you're looking for.

It also definitely takes more time. Every time an underwriter has to go back and explain to agents or brokers why their client didn't get the best risk, it definitely, absolutely, positively takes more time to respond to those requests. Underwriters also get involved much more in working with the clients directly.

We're also seeing an upsurge in the number of "not taken" policies. How much expense is going to underwriting these risks and never placing the policy because the client didn't end up with the product that he or she was sold originally?

Mr. Rains: I want to talk about our different quotes. Carl had some well thought out comments about the various quotes and I feel I owe it to you to give you a different perspective. With respect to the quote that the number of preferred classes you have to have is at least equal to what your primary competitors have, let me restate that in a way that somebody might have considered in the early 1980s—you must invest in securities at least as risky as the ones that your competitors are buying. Think about that one a little bit.

The other one is, ignore underwriting at your peril. There will be a paradigm shift. I would say that having more classes and lower prices is not a paradigm shift. Being out there on the edge means finding new markets and blazing new trails and finding

ways to sell the products and services that you do. If you do, you will get compensated adequately and profitably in the long run for your company.

Mr. Klein: Thank you "three" team. Now it's time for questions.

From the Floor: I filed in New York a five-class term product. They said my whole portfolio had to have five classes or they wouldn't approve it. Does anyone know anything about that? We don't want to do it on permanent products.

Mr. Atkins: So you're saying that in New York State you wanted five classes on one product and they said, if you're going to do it on one product, you have to do it on everything?

Ms. Mary Bahna-Nolan: We have a New York subsidiary and that is a New York requirement. You can't stratify risk differently by product type in New York. So you can have a multiple preferred class system, but if you have it on your term, you have to have it on your universal life and on your permanent as well.

Mr. Henry B. Ramsey: Regarding that point, my experience at other companies was that the New York regulator asked, "Are you going to do this on your permanent policies?," and then insisted that the answer be yes. Not that they said, "OK, if you introduce this on term, you have to do it on all the others." So I think the timing is an issue. We said, yes, we'll do it eventually. We intend to do it and that was satisfactory to the regulator. I'm not sure that the company has actually gone ahead and done it yet, but having stated the intent was sufficient to make the regulator comfortable that we weren't unreasonably differentiating on term versus permanent.

Mr. Jim Thompson: The general information I have is that companies with the higher number of preferred classes get higher "not taken" rates. Of course, "not taken" means that you have underwriting expense and no premium, which raises your cost. I was wondering whether the preferred team and the "six" team had any comments on this.

Mr. Atkins: Preferred classes can lead to higher "not takens" if your marketing efforts and your field force are not in tune with your underwriting. So it's essential to make sure that they are. They know what to expect. They know what type of business to solicit by offering and promising different types of rates. So to the extent that your field force has some idea as to what to expect from your underwriting, you'll find they will shift their target market. So if they know that you have a preferred bent, then they are going to send the preferred customer to you. They will take the ones who are on the bottom end of the scale and they will send them

somewhere else. So that does mitigate some of that "not taken" risk, but it is certainly a very real risk that has to be managed along with the others.

Mr. Macero: Once again I'd like to emphasize the education process of the multiple preferreds that is offered. It is not our position that we say to our companies and to our company agents, "Sell standard and if you then qualify for preferred, you'll get a little extra bonus at the end of the process." We're saying that if they understand the different stratification of the preferred that we offer and if we do a better job educating there, we'll all be more successful.

Ms. Richards: I think the hard part though is that with the way our preferred classes or criteria are designed, applicants really can't predict whether they will qualify as preferred. To really stratify the risk, you have to use the blood profile and most clients don't know what their liver function test results are or what their cholesterol/HDL ratio is. They don't know what their alcohol marker is going to turn up. They might have a good clue, but they probably don't know. I think if you're really going to stratify risk, you have to use some of those more sophisticated tests where clients aren't going to know the results. So you will have to expect the high "not taken" ratio from clients who are disappointed with the end result.

Mr. Rains: I'm sure that agents selling the policy have gotten exceptions before for a client who's a couple of pounds overweight or for a client smoking one cigarette every 37 years or however long the guy said it was since he smoked last.

Mr. Macero: The education that we're talking about means telling agents not to tell applicant A, he or she is going to be here, and applicant B will be there. The education we're talking about has to do with whether the agent has that discussion with the proposed insured explaining the different categories of preferred that may be available as a result of the underwriting process.

Mr. Klein: I'm going to throw out one thing on the question about the "not taken risk." If you're talking about six-classes versus three and someone doesn't meet the best class that was offered to them, when you move from the first class to the second out of six-classes, it's maybe a 10–12% difference in premium. The customer is more likely to take that than the 40–50% difference going from preferred to standard under three classes.

Mr. Rains: That's instead of applying to a new company to try to get a better rate.

Mr. Richard H. Gudeman: Team Three made the argument that the United States consumer and many of the regulators expect a high percentage of the purchasers to get the best rate. I did not hear an adequate rebuttal of that from the "six" team.

Mr. Atkins: I guess what you're saying is that all consumers think that they deserve the lowest price and are disappointed when they don't get it. I'd certainly want the best price for myself, and I think you probably all want that as well. But the reality is that we pay different amounts for different things, based on our ability to negotiate deals. The world is not a socialistic society. Life Insurance is a voluntary-type purchase. It's more a matter of educating people to the range of possibilities rather than starting off with the absolute lowest price and working your way backward.

Mr. Robert A. Gabriel: I see that some companies are splitting their smoker classes into two or more, or even three smoker classes. It seems kind of strange, but I guess I can intellectualize a smoker who jogs or maybe a smoker who only smokes five cigarettes a day instead of 30 cigarettes a day. Is that how they're distinguishing between a good smoker and a bad smoker or are they doing it some other way? How about cigar smokers?

Mr. Macero: I've seen a little bit of that stratification in the smoker class itself.

Mr. Gabriel: Yes.

Mr. Macero: There are slightly different rates for a one-pack smoker per day versus a heavier smoker. But I generally have not seen that as a broad move within the marketplace at this time. It may go that way, and then we'll have to contend with it, if that's the wave of the future. But I think that's the exception at this point, rather than the rule.

Mr. Atkins: Some of the companies that I've seen that have multiple smoker classes use the same criteria to distinguish between the levels of smoker classes as they do on the nonsmoker side (for example, family history, height, weight and cholesterol measures). Jennifer, you may know something more about that as well.

Ms. Richards: That has been my experience. As you pointed out, they use the same criteria, except in the smoking criteria. I've never heard of differentiating between one-pack-a-day smokers versus two-packs-a-day smokers. That seems incredibly difficult to select. How can you tell?

Mr. Macero: That's the problem and we agree with that. That's why I have seen one or two companies going that way, but how can you really tell? That's why I don't really think that's going to be the wave of the future. It's going to be either smoker or tobacco or nonsmoker or nontobacco.

Mr. Rains: I think I remember there was a preferred guideline survey out a few of years ago that indicated about 40% of the companies that had preferred programs in general had extended that preferred program to their smoker classes. With some of the experience that I've seen, and I know it's not true for everyone, the loss ratios and the adverse experience on that preferred smoker class were incredible. I actually think there's a movement away from stratifying the smoker between preferred and regular smoker. I still think there's a super preferred smoker and that's the guys who smoke but don't inhale.

Mr. Kevin Reopel: I'm curious. After the smoker/nonsmoker basic differentials hit the markets, a lot of data were gathered to give good information for pricing. I'm wondering, what kind of data are being gathered for the super preferred classes by insurers, reinsurers, or, what's more important, the Society of Actuaries that can shed some light on all of us on this?

Mr. Rains: Let's turn that over to Al because I think you're doing that.

Mr. Klein: I chair the Society of Actuaries Task Force on Preferred Underwriting and Large Amounts, and there are actually two things we're working on. One is, our second survey of preferred underwriting criteria and results as to what companies are doing and what the practices are. We're going to finalize that report, hopefully, this summer and get that out in another couple of months. In addition to that, we are also doing a preferred mortality study. I will call it that, but it's really a study where we're looking at each of the individual criteria like, for example, cholesterol and keeping track of what the cholesterol reading is on every insured. Then we will be able to do a mortality study on each item (for example, on all the cardiovascular factors). We're hoping to start collecting data after everyone's done with their Year 2000 issues. A letter should be going out to a number of companies sometime this fall reminding them that we're trying to do that. We're trying to collect data as of January 1, 1998, going forward, so please go back and encourage your companies to contribute to this. I think it's a unique study that has never been done before and it will also allow us to be able to check all the laboratory results, MVR results, and really see how mortality relates to those items. That's what we're working on now. Additional questions?

Mr. Lawrence Engel: I have a question for the "six" team. If you have a multiple table preferred and super preferred, typically what percentage of your business do you anticipate in your pricing would be in your super preferred class? Also, what percentage of your actual business paid ends up in your super preferred class?

Mr. Macero: In the design of those kinds of programs, I often see that in the super preferred class you're probably looking at about 25% qualification and then possibly in your preferred it would be probably 40%. So you'll have a total of 65%

in the preferred category and then 35% or maybe a little less with the residual standard. Now with agent selection, those percentages certainly can increase. But as long as you are going through your underwriting audits and are hitting the criteria, even if those percentages are a little higher, we still feel as though your profit margin and targets will be met.

Mr. Atkins: Does that answer your question? I agree wholeheartedly with Carl that you want to target the underwriting guidelines to the population of insureds out there, so that your prices match up with the mortality of that group. But then what you actually experience could be vastly different than that, because the market is going to select who comes to you. If you have a very good super preferred rate and you have a much higher priced residual rate and there's a competitor that's in between, what you will find is that the really good risks come to you on your super preferred class and maybe the ones that would have fallen into your residual class go to your competitor. That's OK though because you're getting more of the good lives. So the actual results you get may look quite different than what you had used to stratify the population to start with. You go back and do the audits to make sure that the people you're putting in the classes meet the criteria; then you know you're OK.

Panelist: In my opinion, that has something to do with how tied you are to your distribution force and what they will do once they get out there with your products.

Mr. Atkins: Right, if your distribution controls the applicants and they're not redirected anywhere else, then you're really not in a competitive environment. If that's the case, then you can do whatever you want, and you'll get the results you want. But if you are in a competitive environment, then you start to get this flow of applicants in and out of your portfolio.

Mr. Michael F. Conwill: About a week before this meeting, a new product came across my desk in which one of the criterion that helped give a person credits towards qualifying for super preferred was ownership of pets. I was wondering to what extent you see companies developing preferred criteria that are kind of marketed toward something that will play well to the prospective client as opposed to having real science behind them?

Ms. Richards: How much mortality improvement do you get for ownership of a pet?
Mr. Macero: I think that question is somewhat similar to the stratification of the smoker question, where some companies may differentiate between single pack and multiple pack cigarette smokers. Yes, every company may come up with a different spin like that, but I think that might be a very, very unusual circumstance. I have

heard of that. I'm not really too sure how much credit to put on it. I think it would be rather minor at this point, but I think it's going to be a very, very singular event and not a general move whatsoever.

Mr. Klein: I actually had never heard of that, but I have heard and read of detailed scientific studies paid for by government grants that say that healthy, happy people who have pets live longer.

Mr. Macero: Cats more than dogs.

Mr. Rains: I have not, however, heard of any of those studies that indicated the same level of confidence about how much a 25 point difference in your HDL ratio would help you out.

Mr. Atkins: Let me add one more thing to that. I don't think we're going to end up with pet ownership as being a preferred criteria across the board, but it does make a difference for the elderly. If we're going to extend the normal issue ages into the upper 80s and 90s, then consider pet ownership because pet ownership is correlated with longer lives at those issue ages.

Mr. Klein: I did want to add something to that too. In the preferred study that we did nobody mentioned pets being one of the criterion. We did ask what other criteria are being used. Other criteria will come out. The labs and the medical community are finding other things that they feel will help determine mortality. So there will be some new measures coming out in the not-too-distant future.

Mr. Jack Greenberg: Over the years I've been involved in many situations where people have shopped around cases. Sometimes it's amazing to see the differentiation between the quotes that are returned in terms of the underwriting—anywhere from uninsurable to middle substandard all the way down to standard—on the same case. Given the fact that these statistics here seem to suggest a 20% differentiation, which is less than one table rating, I wonder to what extent it is truly possible to differentiate or show a real difference between the two: super preferred versus a lesser preferred situation?

Mr. Macero: Many companies do come to us and ask a very similar question: how do we distinguish among a preferred elite, a preferred plus, and a preferred? Various mechanisms may be used. For example, you definitely have different criteria within each of those preferred classifications, and companies use a method that is defined in this way: we can use a certain amount of flexibility within those classes, provided that all but one of those preferred criteria are met. We can possibly have a 10% deviation off of that one criterion that isn't quite met. So using

a formula in that fashion, you can still maintain the integrity of the individual preferred classes within the different preferred criteria spectrum. Does that help you at all?

Mr. Greenberg: I guess my point is that I've seen so much differentiation on the same case that it's just hard for me to believe that underwriting has gotten to such an exact science where we can now differentiate between a 20% difference between super preferred and a lesser preferred. That's less than one table rating. That's my point.

Ms. Richards: We agree with you.

Mr. Rains: Correct.

Mr. Atkins: I would respond that indeed the measurements we're doing do show that kind of a differential and that reflects itself in the price of the products, and people are willing to undergo the underwriting process if they can get a 20% lower premium. So if you don't want to do it, if you think it's too fine to really tell the difference, then that's one way to go. I think you can tell the difference and the companies that distinguish between the two will end up selling much more business and more profitable business.

Mr. Klein: All right, I think we have time for one more question. I do want to get one more vote in.

Mr. Michael C. Eastburn: I wanted to ask the "six" team how are they prepared to deal with exceptions? Do you think it's realistic to think there's not going to be large producing agents who are going to ask for exceptions?

Mr. Macero: Well, I think the mechanism or the formula that I just explained will hopefully answer some of those exceptions, but it is our position that you do have to have flexibility; there's no question about it. But how far you go in the exceptions has to be each individual company's decision. That may go to answer your question about why one company defines an individual as a super preferred and another company defines that person as a preferred. But companies do have to make those decisions on their own, as far as how flexible they will be.

Ms. Richards: I think you need to look at your distribution channels and your underwriters too and ascertain how many exceptions you think will be made and include it in your pricing at the beginning.

Mr. Rains: When you have a large agent like that, what percentage of your distribution can he or she bring to you. If it's a lot and the agent has the clout to get exceptions, that's also going to hit your volatility rather hard.

Mr. Atkins: Probably that volatility and that exception rate was in your pricing before. It's just that now there are a few more opportunities to make exceptions.

Mr. Klein: Thank you everyone. Before we go, let's take another vote. Did anybody change since the second round? Okay, how many changed to three from the second round? How many changed to three from wherever you were? Okay, that's eight more.

How many changed to six from the second round? How many changed to undecided? Now let's see where they came from. I'll ask the person who voted for six . Did you leave three or undecided? Left the three. And the other eight, how many left the six? Just one. And how many left undecided? Seven.

Here are the final totals: 54 for the "three" team, 45 for the "six" team, and two undecided. So at least we changed some of the undecided votes!