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What's Hot in Term Products?

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Moderator: EDWARD A. TURNER
Panelists: MARY J. BAHNA-NOLAN
RONALD L. KLEIN
TIMOTHY C. PFEIFER
Recorder: EDWARD A. TURNER

Summary: The action is fast and furious in today's term market. Staying current on a variety of topics is crucial for successful product development. In this session, attendees hear the viewpoints of individuals from different perspectives within the industry since the panelists are from a direct carrier, a reinsurer, and a consulting firm.

Mr. Edward A. Turner: I'm with the North American Companies. I will first introduce the panelists and then talk a little bit about the format that we're going to use. The first speaker will be Tim Pfeiffer, who certainly needs no introduction to most of you. Tim is a principal with Milliman & Robertson (M&R) in Chicago. He is a recognized expert on a variety of product development issues, including term insurance. The second speaker will be Mary Bahna-Nolan, who is the second vice president and pricing actuary at the North American Companies. Mary has extensive experience with term insurance from both the direct side and the reinsurance side. And last, but certainly not least, is Ronnie Klein with Swiss Re. Ronnie was recently promoted to executive vice president and chief pricing officer with Swiss Re Life & Health America, Inc.

What we're going to try to do is present current topics on term insurance from three somewhat different viewpoints. We've tried this approach a couple of years ago at another meeting on this same topic. Tim comes from a consulting background, and he will give the perspective of the consulting business as well as his experience with the direct companies and reinsurers. Mary will certainly be coming from the perspective of a direct carrier that's having to deal with the day-to-day challenges of being in this competitive market. Ronnie will bring the viewpoint of the reinsurers to this issue. For those direct companies who are active in term business, you know the reinsurers have become a very critical factor in this marketplace.

What we're going to do initially is ask each of the three speakers to make some opening comments about what's going on with the term business and then we'll have some interaction among them. There have been several other sessions at this meeting that have touched on the subject of term insurance. We'll try not to be repetitive on most issues. We probably are not going to discuss the intricacies of XXX and how to calculate X factors. We would rather talk about the broader term market—where it's going for the rest of 1999 and where we see it going in 2000 and beyond.

Mr. Timothy C. Pfeiffer: I'm just going to comment on what we're seeing in the term business right now. I would say for a considerable number of companies what is going on right now is an evaluation of the impact of XXX on their product line. We've seen the term business evolve over the last few years from a market that was predominantly a five- and 10-year market at one point. Now this market has evolved into one where much emphasis is being put on the 20-year products and, in the case of certain companies, 25- and 30-year products. Under most evaluations of XXX's impact, I believe most companies think it's going to be difficult to maintain 25- and 30-year guarantees, though we're certainly seeing companies push those products to a certain extent prior to year-end. We are also seeing companies focus on the 20-year product and any fine-tuning that can be done on the 20-year product in order to keep that product viable beyond 1999 at competitive rates.

About a month ago we had a seminar on XXX in Chicago where we had representatives from approximately 50 companies. We took an informal poll of that group to see how many of those people felt that the most important issue in selling term insurance was to have a very competitive rate with limited guarantees, versus a less competitive rate with very strong guarantees. The response was maybe a little surprising since the majority of the people in the room felt that the term environment is more characterized by very low rates and limited guarantees. If that is any indication of what life will be like in the XXX environment, I think we will continue to see low rates. This is opposed to the general media's prediction that rates will go up significantly. I don't think rates are going to go up significantly. I think rates are going to continue to drop in some situations. We'll see guarantees scaled back, however. There's some recent indication perhaps that the reinsurance market is tightening. Ronnie may put a different spin on this issue, but some companies have perceived that in the latest round of pricing it's been a little more difficult to secure the reinsurance on the terms as attractive as previously available.

In a XXX environment, I think we will see some new entrants. We've already seen new entrants into the term business in the last couple of years—players that really have never been in the term business competitively in the past. I think in a post-XXX environment we will see a number of other big competitors come into the business. I think the aggressiveness in the term market of the future will not be among players who have been in the term business for a long time and have empirical data with which to guide them in their choices of X factors and other product assumptions. Instead I think the aggressiveness will come from companies who have virtually no experience and will take more aggressive steps to move into the term market.

I will not comment on specific details about profit goals, but profit margins on term business continue to fall. Many companies are doing some subsidizing of profitable sales with their less profitable sales. In many cases companies are selling products with profitability of 1% of premium on an aggregated basis. The theory is they want to maintain market presence and to secure distribution. Perhaps some of these companies believe they can convert term business to permanent products later on.

One of the impacts of not only XXX but also the illustration regulations, which I think will come into greater play on the term business in the future, is the desirable effect of companies needing to improve their experience studies for both expenses and mortality. You simply can't do an adequate job of establishing certain items that XXX requires unless you do some type of periodic mortality study. For illustration regulation compliance, clearly you have to go beyond mortality and do some expense analysis. I think these developments will have some desirable implications because there are clearly some companies who have been a little bit lax in terms of performing experience studies.

Finally, as one strategy we've seen some companies view the smoker business as perhaps one area that other companies have tended to neglect. Many companies have not priced the smoker business to be competitive, and perhaps there's some avenue for particular companies to establish themselves in the smoker market. Perhaps for at least certain types of smokers there may be a more profitable source of business since the competition isn't quite as severe.

Ms. Mary J. Bahna-Nolan: Since the beginning of the year we've seen a lot of movement by companies positioning themselves for an "XXX fire sale." We have seen this being done through rate reductions and/or reductions in policy fees from some carriers. I don't think we saw a lot of new entrants into the marketplace, at least over the first quarter of 1999, but we certainly have seen a repositioning of companies to try to gain some market share. We've seen a lot of movement on the 20- and 30-year term plans, which we certainly expect to be impacted significantly by XXX either in the form of higher premiums or shorter guarantees. More surprisingly, we've seen a lot of activity on the 10- and 15-year term plans. Based on some of our analysis, we didn't really expect XXX to have a significant impact on the pricing of those products. We continue to see a lot of competition in those shorter level premium products.

One issue we've seen in our recent product development is what I would call tightening in the reinsurance market. To echo some of Tim's comments, I don't think the rate reductions we're seeing currently are being fully supported by aggressive reinsurance pricing. I think the direct companies are focusing on ways to utilize technology to reduce expenses and to increase efficiencies, speed of underwriting, and new business processing. By making the cost of issuing the business lower, we can pass those expense savings along in our premium rates so we're not only relying on reinsurance and good mortality to drive rate reductions.

I know we are hoping to see some stabilization in the term market. I think we are seeing that right now, but I think that stabilization is short-term. I think right now companies are really focusing on what they're going to do next year, trying to get mortality studies in order, and figuring out the X factors and how they will work with the appointed actuaries in order to get them comfortable with the term pricing. But I do think we are going to see another round either of rate reductions or, more likely, some commission enhancements and bonuses this summer and early fall. I think companies are really trying to capture market share, especially as we start seeing more and more states truly adopt the XXX regulation. I know many companies have imposed freezes on product development, new products, new rate changes, etc. because of Y2K issues going into the end of next year. We'll probably start seeing a lot of the changes come by the end of the summer or the beginning of the fall because I think they'll be pretty hard pressed to implement anything going into November or December.

Mr. Ronald L. Klein: As reinsurers, we get to look at a lot of different companies' mortality studies. Over the last couple of years a lot of changes have been made to the underwriting standards for companies, so they don't have any mortality experience that they can depend on. Companies have now settled in on their number of underwriting classes and are starting to get some emerging experience. They're starting to see that maybe the reinsurers were correct in the level of their mortality assumptions. The direct companies themselves are now setting their mortality at those levels and saying, "Hey, the reinsurers were right, but the reinsurers are building a small profit margin in on their pricing." In that situation, I think the direct companies do not want to pay those profits over to the reinsurers. I think that's what's going on. We see a number of direct companies who typically went out for quota share reinsurance who are now going for excess coverage only. Some are reducing their pools down from eight to four or three reinsurers. As a reinsurer, I find the market extremely competitive. There are a couple of new players in the reinsurance arena who are trying to get market share also, so we're under the same pressures that direct carriers are under. On the other hand, there is a lot of merger and acquisition activity going on, so that's cutting down on the number of competitors.

But I do want to mention a couple of things. One is, I guess no one had mentioned capacity or capital in a XXX environment next year. A lot of our clients are coming to us asking; "What's going to happen next year? How are we going to get rid of all these high reserves?" I've spoken to other reinsurers and they've said the same thing that a lot of their clients are asking the same thing. I think that's going to become an issue next year when some companies will try to tie up reinsurers and their capacity early on. I think the problem that's going to happen is that reserving requirements peak a little bit further down the road under the new XXX, and I think that some of these companies and reinsurance companies might not realize what they're getting into when they guarantee these rates and try to set up retrocession agreements overseas to get rid of the reserves. I think that capacity is going to become a very large issue, and there's going to be a charge for that capacity. I think the direct companies are going to be playing this game. Do I want a guarantee for my 20-year term for 20 years, 10 years, or maybe 7 or 12 years? How much is it going to cost? How much will I have to raise my premium? Tim, I think you are exactly right. It's a matter of if we want low cost or full guarantees? Right now the agents are saying they can get full guarantees. But when all the direct companies come out and you see how much it's going to cost for the full guarantees, suddenly they might be saying the opposite thing.

One other thing I wanted to get into quickly. With the level of demutualizations and restructuring occurring in the industry, we're seeing a lot of blocks of term insurance up for sale. Companies may be selling off blocks of business that they just don't want to update for Y2K. We see this type of activity continuing. We find this a very hot and interesting market.

Mr. Turner: Mary and Tim, would you comment on the general level of mortality experience for term products?

Mr. Pfeiffer: Well, clearly the levels for mortality pricing assumptions are dropping. I see companies routinely pricing their best preferred class at 25–30% of the 1975-80 Table. In some cases they have experience emerging over a period of time that would lend some credibility to that level of assumptions; other times they don't. In terms of companies' actual mortality experience, I guess as a general rule where companies have compared actual pricing mortality, the numbers that I've seen have come up pretty close. Generally I'd say actual experience has been following pretty much 95–105% of pricing assumptions.

Ms. Bahna-Nolan: Yes, I can certainly speak from our company's perspective. We are in a somewhat unique position in that we're one of a few companies that actually has about nine years of preferred mortality experience and about three years of a super-preferred or a second preferred class mortality experience. I think our actual experience has been emerging at least at or better than pricing experience for our preferred and better classes. We were seeing some deterioration for our smoker mortality, but I think a lot of that was due just to our positioning in the marketplace. We've done some repositioning to try to make ourselves more competitive across all risk classes, and we did add a preferred smoker class because we thought we were really being selected against by smokers.

Mr. Pfeiffer: The one area where I consistently see companies having fairly high actual-to-expected experience would be the older age female smokers. For some reason, that seems to be routinely awful.

Ms. Bahna-Nolan: I think we could echo that although I don't think we have enough credibility there.

Mr. Turner: The other question I would like to ask the panel is related to what I think is a commonly ignored issue. We need to discuss lapse rates. I think at times we overemphasize the mortality issue without adequately discussing persistency. I was wondering if the panel members would discuss the persistency issue.

Mr. Klein: I'll certainly start. From our friends in Canada we've seen what disasters could occur with lapse-supported products, and level term plans obviously are lapse-supported products. I think companies are starting to get lapse experience on their level term plans and they're seeing that some experience in the middle years of a 10- or a 20-year level term plan are higher than they expected. Then, both reinsurers and insurance companies are pricing with these higher lapse rates. When I say higher, I'm talking about in the low teens or the high single-digit numbers. I think the experience is showing that. I have a theory about these higher lapse rates. When new preferred classes were coming out, the rates were dropping quickly. You were three years into your ten-year level term plan and suddenly you could get another ten-year level term plan at that age for the same price, so you lapsed your policy. This shows up as a lapse, but I would say it's more of an exchange. But now that everything has settled down, the rates are dropping by a smaller margin. I think when rates settle in, especially when XXX comes, the level lapses will be at a much lower level. I'm very nervous about some of the pricing that has been done recently with 30-year level term plans with lapse rates up in the 10% range and for many durations. I'm very nervous about that.

Mr. Pfeiffer: Yes, I would say that I think the term business is "pseudolapse supported" as opposed to "lapse supported" especially given the heaped commission patterns that are out there now. You do need to have the business in force for at least some period of time after that first year, and then at some point down the road ideally you'd like it all to lapse from a maximizing profit perspective. But one of the things we've seen is actual lapses from a number of companies at almost double what its priced for. These are companies who compete fairly actively in the term business, and their pricing assumptions may have been in single-digit types of lapse rates. Their actual lapse experience has been creeping into double digits, and given the durations when this is happening, it does have some negative profit impact.

We try to encourage companies to do a lot of sensitivity testing on the lapse assumption. The focus has been on mortality, but it's important not to neglect the lapse side also.

Ms. Bahna-Nolan: Our experience has been a little bit different than what Tim's been seeing with respect to our persistency. We are seeing pretty low lapse rates in all of our products. Some of that could be a function of our segment of the market. We tend to be focused a little bit more at some higher ages, so we are seeing single-digit lapse rates basically across the board on all our products. As the length of the level premium increases, the persistency improves.

Two areas that we are seeing higher lapse rates than what we originally anticipated are with respect to the standard class and also probably more significantly with respect to the smokers. In those classes, we're seeing a definite difference between the actual versus expected lapses. I'm not exactly sure what the reasons for this are. It could be just a result of more and more companies entering the market with preferred definitions and different classifications for preferred. The same could be true for smokers with the introduction of the preferred smoker tobacco class. People leave their current company to get a lower rate in a better risk class at another company.

Mr. Turner: Another area I would like to explore is what I would call advancement in the pricing approach for these products. I am interested in both recognition of the expenses, both marginal and overhead, in term pricing as well as more differentiation of the expense, mortality, and persistency assumptions by cell and product type. Would any of you like to comment on how well companies are doing in this regard? Are companies really focusing on the expense issue or are they just ignoring it?

Ms. Bahna-Nolan: Our competitors are ignoring it and we are looking at it. That's just the only way I can justify the rates that they have. But, I don't think anyone is ignoring expenses. I think some may have been underestimating the cost of actually putting a term product on the books and maintaining the term business. I think today it's imperative that companies really focus on the expense levels if they want to be competitive in this market. I think going into next year it will be very critical if premium rates are not guaranteed since we will need to certify illustrations of term products.

Mr. Pfeiffer: Yes, I guess the area where I see the most "gamesmanship" would be in the allocation of expenses among product cells. I think a number of companies choose expense allocation methods that would probably disproportionately put expense into some of the older age cells in order to improve the picture at ages 35 or 45. I guess my sense is that there are very few companies that are truly pricing with fully allocated expenses, and I don't think that's going to change. When you have a very price-sensitive business like term insurance, companies are going to look for whatever expense allocation method they can use to improve their situation. Also, I think there are probably other lines of business that have more egregious expense allocation issues than term.

Mr. Turner: From my perspective the expense issue really has at least two important pieces. One is making sure that you can really measure the marginal cost of being in this line of business. What does it cost to do a paramed exam? What does it cost to do an attending physician statement? How much time does it cost an underwriter to process a case? The other big component is what I would call paid ratios. This ratio compares how much of the business actually gets paid versus how much business comes in the door that requires you to spend time and money. This marketplace, as all of you know, is very efficient. Customers have a variety of ways to obtain the product. If you're in the brokerage business, you must work very hard to control multiple submitted cases on the same applicant since an agent can be licensed with several term companies because of price, rating class, time service, etc. The agent submits applications to three or four companies and the first one to issue a policy with the best rate often gets the customer. When you start factoring that into your pricing, realizing that you're only one of those four companies chasing this case, you can spend a fair amount of time and money processing the application and have nothing to show for it. With some policies having premiums in the $300–500 range, building this cost into your pricing structure is extremely difficult. From my perspective, if you're going to make money in this market, you have to manage the mortality side. You also have to be realistic about lapses, but you really have to ride hard on expenses. Certainly in the under age 45 market, under $1 million of face amount, I believe the expense issue is the most crucial factor if you are going to be truly profitable with term insurance. This is an area that I think deserves a lot of scrutiny.

Mr. Turner: Tim, you made the comment earlier that at the M&R seminar, a straw- poll impression of the audience was that lower rates would be the more dominant approach for post-XXX products instead of limited guarantees. I would ask Tim and the other panel members whether they think that response might be different by distribution channel.

Mr. Pfeiffer: I think even people buying term insurance in the bank channel, for example, understand that it's a price-driven business and are going to be very capable of doing pretty efficient price shopping. If we're talking about distribution through the brokerage channel, there's going to be much more sensitivity to product guarantees, but I think the nature of the beast is that it's a price-driven product. I think when you have as many companies as we have in this industry who are all going to be pricing term business effectively at the same time across a multitude of distribution channels, there's going to be a lot of impetus to keep the rates down, and, if guarantees need to suffer, I think they will suffer, but I would see the differences among distribution channels being modest.

Ms. Bahna-Nolan: I guess I tend to follow Tim's impressions, although I think for the direct-response channels (i.e. SelectQuote, QuoteSmith, etc.), the guarantees are probably of much more importance in the product. In the direct-response channels, there is a lot less interaction with a potential customer, so disclosure required from sales illustrations is more difficult. We can no longer do side-by-side comparisons of nonguaranteed rate products. Ten-page illustrations for a term product are tough to sell, so guarantees are important. However, I don't know how much a potential customer would be willing to pay for the guarantee. While I think a 20-year guarantee will be very important in this market, I think we might see more of a shift down to shorter level premium products in order to obtain full guarantees with only a modest rate increase.

Mr. Klein: I don't know what's going to happen in the market. Perhaps for the short term, some companies that are capital-rich, the larger companies, might keep their products and their guarantees unchanged and probably increase sales. I also think that there may be some ways around the regulation that some of us will discover. Perhaps some reinsurers will invent some really innovative ways of getting rid of the capital at very low cost. Things like this could happen and I think at least for a short period of time that the same guarantees will be around. I'm very nervous about the environment. I hope that either the rates go up or that the guarantees go down, but I just don't see it happening.

Mr. Turner: Back to your original comment about the slope of these reserves, the big numbers tend to be a few years out. We've been talking about a "big bang" occurring on January 1, 2000, but in reality, the basic reserves can be one-half Cx for the first year. Companies might simply decide they have a little time to think about what to do. There might be a temptation to see how the market goes. In this situation, a company does not necessarily have its ultimate portfolio in place on January 1, 1999, and they would simply see how things develop.

Another question would be in terms of the multiple class structure. For some time, the market seems to be working toward more and more classes and finer and finer differentiation of the risk. What trends do the panel members see in that area and do they see any impact by XXX?

Mr. Klein: I now see underwriting classes being reduced by one or two classes. We're not seeing any more eight class term products. On the other hand, some of the companies that were slower to get into the market are coming up with one more preferred class. With XXX I think there may be even a couple of more classes cut out because the lower classes might just create some deficiency reserves, depending on X-factor calculations and individual company mortality experience.

Ms. Bahna-Nolan: I would agree with Ronnie. I would expect to see little new differentiation of the risk classes as we go forward into 2000. I think we are starting to see a slowing in the introduction of more risk classes today. We put a lot of focus on the X factors with respect to XXX and what role they'll play. At least from some of our analysis, the bigger impact is on the basic reserves and on reserve segmentation. Basic reserves are the same regardless of your risk class. These "super-duper, walk-on-water" preferred risk classes could be very expensive from a basic reserve perspective. In 2000 and the XXX environment, the impact on basic reserves may not make it worthwhile to have eight different risk classes.

Mr. Pfeiffer: I would agree, too. I would see it more as a plateauing rather than a pulling back on underwriting classes. I think a number of companies will probably stick with the number of risk classes they have. Maybe the big issue is basic reserves and not deficiency reserves, but rest assured if your mortality experience comes in very poorly relative to the X-factor assumptions, suddenly the deficiency reserve issue is not a minor issue.

Mr. Klein: As a reinsurer, one of the things I'm really nervous about is having this attractive X factor and then having the experience go more poorly than you expected. As a reinsurer, I'm paying a lot more claims because, as we know, the direct companies now give all the mortality risk to us. Now that reinsurers are paying the claims when there's a sudden change in the X factor we have to hold a higher reserve as we're paying more claims. I'm going to take a hit twice now. Sometimes I don't understand the real intents of the XXX regulation. I'm still quite optimistic that companies will come up with something interesting to get around this regulation.

Mr. Turner: Just another comment on the number of underwriting classes. With XXX to the extent that companies move to nonguaranteed products and illustrate them, therefore complying with the illustration regulation, I would suspect the more classes you have, the more problems you're going to have with those illustrations from a distribution channel perspective. Often agents tend to show the best possible class to a customer. This can be very difficult administratively if the customer is actually a different class from the one originally illustrated. It tends to require some additional paperwork for compliant illustration purposes, which is not inexpensive to perform. Back to one of Ronnie's comments. The X factors are very much influenced by your own experience, yet as you move into the older ages the impact of your own experience seems to be mitigated considerably. If you're focusing on the over-age-50 marketplace, even in the 10- or 15-year products or you have extremely good experience, there are some mechanical aspects of the X-factor calculations that tend to reduce the positive impact of your experience. We have indicated that 10-year products are less impacted by some of the XXX aspects, but when you focus on 10- and 15-year products to 55–75 year-olds, you are going to have some deficiencies simply because of the limitations on what you can do with the X-factor calculations.

Another question that I would ask the panel members is, what comments might you have about the general distribution marketplace for term business? We have seen a shift from the traditional agency system to more nontraditional channels as a way of selling this product. Is that a trend that's likely to continue?

Mr. Pfeiffer: I continue to believe that the traditional agency system, whether it be career or brokerage, is really dominating, and I don't think that's going to change a lot in the future. There's a lot of discussion about wire houses, banks, and Internet sales. My impression is that there are some success stories in the wire houses. The banks are a different story. There has been a continued difficulty in achieving a lot of success in bank sales. The Internet sales continue to be slow, but it has served reasonably well for lead generation purposes for many companies. We continue to say this is a product that's sold, not bought, and even though this may be less true of the statement for term versus other products we sell, an agent and the face-to-face sale is still important.

Mr. Klein: I would agree completely. Has anybody tried to get on the Internet and actually buy a life insurance policy? My experience was I couldn't fight through the screens. So there are some success stories, but because of the difficulty of getting through it's not as easy as it sounds. It's not like Amazon.com where you do one click and you get your insurance policy.

Ms. Bahna-Nolan: I think that we will continue to see the brokerage and the career agency systems flourish with this type of product. I do think though that the alternative distribution channels such as the financial institutions and direct response will continue to gain market share. But I think there's going to be a lot of pressure for product changes for distribution channels. We're already starting to see the pressure for developing a variation to the product that we currently sell with simpler underwriting, faster issue, etc., even if it means a slightly higher price. The ability to get 24-hour turnaround on these products I think will be very important, and we'll start to see a change in the product and the underwriting as we go to these different distribution channels.

Mr. Pfeiffer: You can see the distribution conflict that takes place within a lot of companies when you just think about the pure economics. You would expect that an Internet-sold product would be dramatically cheaper than a fully commissioned, agent-sold product. It's very difficult for companies to pull that off given the reaction of their field forces. Even with potential advantages of an Internet type of sale, it really hasn't occurred, so far at least.

Mr. Turner: Our experience has been that the alternative channels do tend to appeal to people who have historically not been interested in the life insurance business. The alternative channels give them an access to the product they seem to want to buy. Some buyers through the direct-response channels differ demographically from the people who historically have bought from an agent. We also find that some people will come to the direct-response channels to get information and then go back and still buy the policy from their agent. They think that the direct response agencies give them more information, and they use that information to effectively negotiate with their agent to buy the product. With today's products and the way they work, I think it has actually enlarged the life insurance marketplace by bringing people into the life insurance business that five to ten years ago were not buying.

The other issue is with today's prices and the lower face amounts and the younger ages. The premiums and the commissions are so small that sometimes there just isn't enough money for the broker to sell it. You can have a $200 premium and the commission to the writing agent might be $75. Obviously they can't afford to do much customer prospecting with that amount of money. The well-managed direct-response agencies are structured in such a way that they can make money with smaller premium cases. I think we are going to see a lot of direct-response agencies who are now largely focused on the telephone direct response moving towards the Internet. I think that's probably what's going to improve the Internet service for these products. These direct-response companies really have learned how to deal with a customer on a remote basis. As they move from telephones to the Internet, I think we're going to see some real success stories. I think the brokerage career agency markets will continue to get their share of business because there still are a lot of people who prefer to do business through an agent, but now I think we're seeing growth in these other market segments that agents haven't been able to penetrate or it doesn't make sense for them to pursue. This market expansion actually allows us to really grow, and I think that's a very important part of our business. It allows us to truly sell new business, which isn't just a replacement of someone else's policy.

Mr. John M. Bragg: Ed, this is an extremely fine presentation we've been listening to, and it comes from having these pros on a panel. I was very pleased to hear the panel discuss this matter of lapse rates. We at Bragg Associates, as you probably know, have a very large collective database. We have been recently studying lapse rates. It's very easy to study lapse rates if you have the same block of business reported to you year after year. We have been finding that the lapse rates are higher with smokers. The lapse rate difference between smokers and nonsmokers is not as great as it is on mortality rate differences between smokers and nonsmokers. It's something like half. Incidentally, accidental death rates are definitely different between smokers and nonsmokers. We're seeing mostly two preferred classes on nonsmokers and, at most, one preferred class on smokers. It is possible to pick out preferred smokers, but I can't see anybody picking out eight classes of smokers. Most companies just don't have any preferred smoker class, but there is some movement towards it and our data shows it exists.

I have a comment about the preferred classes. For nonsmoker males, the preferred seems to be approximately 60% of aggregate males. For nonsmoker females, it's much less than that. It seems as if the nonsmoker females are so good that you can hardly get them to be any better with a preferred split.

Mr. Pfeiffer: I particularly like the comment about the accidental death rates for smokers. That's probably a phenomenon that I've seen in a couple of companies and it's probably something worth looking at more closely.

From the Floor: With bancassurance, what is going to happen if a new version of HR10 is passed? I attended a seminar on bancassurance. At the moment it seems that life sales aren't a big part of the picture, but if the banks have more freedom, term could be attractive to them since it is a relatively easy thing to sell. One point that is raised is that the banks want simplified underwriting. You can't take forever. The policy has to be issued in a short period of time. It would seem as if that would be a natural for bank people to sell.

Ms. Bahna-Nolan: Yes, I think term products will become a bigger part of bancassurance sales going forward. I think we have a couple of obstacles we have to overcome. Companies have to find a way to simplify the underwriting process without increasing the premium rates too dramatically. We also have to find a way to issue the business a lot faster. Banks are used to instant decisions and being able to walk in, purchase an annuity or a CD, and walk right out. That's what their customers are used to doing, and we need to find a way to provide this level of service instead of a three-week turnaround we normally provide. But we need to do a lot of education with the banks so that they understand the relationship between the pricing and the underwriting. As more companies work together and as we see more of the Citigroup type of corporations going forward, I do think we'll see more and more of the insurance being sold by banks.

From the Floor: One point that was raised in the seminar was that price may not be a big issue; that people who might be buying these policies may not be the superaffluent.

Ms. Bahna-Nolan: I don't think price is going to be the major driver in the insurance, but I do think that the differential between the premiums can't be so great that it's unreasonable.

From the Floor: Are bank customers going to be able to compare prices on the Internet?

Ms. Bahna-Nolan: They certainly can compare prices on the Internet. Rates are also advertised in *The Wall Street Journal*, on TV, through 800 numbers, etc.

Mr. Turner: Our experience has been that the banks are concerned about later being embarrassed. I think if they are selling term at 10–15% more than the marketplace, they can justify this situation as providing a general service to their customer. If they're 40–50% off the market, then I think they're concerned about later having to explain this outcome to their valued customers.

Mr. Klein: I've seen in some of the research we've done that the bank executives are afraid of two things. One, they're afraid of mortality risk. Everything is a fee and a percentage. Mortality goes up and mortality goes down. They don't like that. It might be good for the reinsurance market, but I don't think they want to keep any of it.

The other thing is that bank employees do not like to talk to their customers about certain subjects. They don't like to ask certain questions. It's just a philosophy in the bank. It can be very difficult to start asking medical questions.

Mr. Robert J. Tiessen: It seems that XXX will likely increase the cost of term products. With the use of X factors and the greater select factors, the cost of permanent products would be helped by XXX. Do you see a switch in the distribution between term products and permanent products as a result?

Ms. Bahna-Nolan: I definitely think that the cost of permanent products like whole life (WL) will probably come down, but I still don't see term products being replaced by WL products. Where you may see some replacement is for universal life (UL) products in the segment of the market where they want very long guarantees. There is a segment of the market that wants a term product. They don't want coverage for a WL or coverage until they're 100 years old. I think that segment will continue. I don't think that goes away with XXX.

Mr. Pfeiffer: I'll comment on your first premise, which was that term rates will go up. I don't think term rates are going to go up. I think they're going to go down and guarantees will shorten, but I think the focus will continue to be on price unless interest rates pop up. Other products, like UL, I don't see as being reenergized. I think the term buyer is still going to be the term buyer and there will be plenty of cheap rates to buy.

Mr. Larry N. Stern: I have a question about the policy fee. It seems like a few years ago, maybe 10 or 15 years ago, the policy fee was $50 a policy, then it went to $60; we've now seen $70, $75, $100, and even $120. I think as companies try to pull the fixed cost of acquisition of the business and maintenance of the business into the policy fee, it will help competitiveness especially at the higher face amounts and to the extent that the policy fee is noncommissionable, it gives them even a better advantage. Do you think the trend toward higher policy fees is going to continue and what impact will that have on the overall competitiveness?

Ms. Bahna-Nolan: I think that there will definitely be a trend towards the higher policy fees. I don't know if we'll see policy fees above $100. I think part of the reason for the increase in the policy fees was that it was a way for companies to become more competitive. With the general mechanics of how you calculate deficiency reserves under XXX, the policy fee plays a fairly big role in that calculation for the deficiency reserves. Especially for some of the lower ages and lower face amounts that policy fee is really all that's going into the product, so I don't think we'll see a trend towards low policy fees like $35. But I don't foresee them going from $100 to $200.

Mr. Turner: What about the commissionable policy fees?

Ms. Bahna-Nolan: I think that there's probably going to be a change in the commission structure, depending on the approach that companies take. If guarantees shorten, we may see the commissions come back on the policy fees. If guarantees continue to stay longer with the premiums going up, I think we'll see just a general change in the commission structure overall, and I really don't have a feel which way the commissions will go. I think companies will get fairly creative.

Mr. Turner: Certainly in the area of commissions, most distribution channels would suggest they aren't making enough money today, so anything that would suggest lower total commissions probably won't be acceptable. You could make the argument that, if premiums do go up in some situations simply because of guarantees, commissions should move proportionately upward or perhaps there is some commission alternative similar to the common approach used for substandard cases. People are going to look at a variety of techniques, but most likely there's just going to be a windfall on the commissions as rates go up.

From the Floor: I'm just curious on the question about whether the guarantees shorten and the rates stay low. Could we use the state of New York as an example of what could happen? I know some companies have two types of products—one with lower rates with the shorter guarantees and another with longer guarantees that costs more. Can we use New York as an example to determine which way companies will go in response to XXX?

Ms. Bahna-Nolan: I think we have to be cautious to use New York as an overall example. I think there are a couple of things that went on with New York. One, I think some companies are probably underpricing the cost of the segmented reserves and the deficiency reserves in New York. They are making it up on other blocks of business or through reinsurance. Reinsurers are probably underpricing the cost or had very low cost for letters of credit that may not apply to nationwide reinsurance situations.

I also think that the distribution channel in New York traditionally has been different from the rest of the market. It tended to be much more of either a personal-producing general agent (PPGA) or a career agency distribution market. As we move outside of New York, we move much more into the brokerage channel where the ability to explain the increase in the cost may not be as easy as for the career agent and the PPGA channels. I think we can look at New York. Companies came out with shorter guarantees and they didn't sell, and so companies wanted the longer guarantees, but I think we have to be careful not to overanalyze that experience.

Mr. Turner: But, Mary, hasn't it been our experience that there did seem to be a buyer's preference for a 20-year product with a 20-year rate guarantee?

Ms. Bahna-Nolan: Yes, I think that's true. I don't know how much of that is driven by just purely consumer preference or how much of that was driven by the agent's push towards the higher premium product and possibly a higher commission.

Mr. Marvin D. Fineman: You brought up the notion of having to pay higher claims followed then suddenly by X-factor changes. You're getting hit twice. But that sounded to me very much like what you have to do in running your GAAP books anyhow. If you're having higher claims, you have to recognize the probability in the future and take the hit. That brings us around to the notion that perhaps XXX reserves are becoming more GAAP-like in their nature. The question I have is, has anybody looked at the change in the previously stable relationship between statutory and tax reserves?

Ms. Bahna-Nolan: I know that we've taken a look at the impact just of tax reserves and what XXX means to us on a tax-reserve basis and how important it is to minimize or eliminate the deficiency reserve because of the inefficient use of surplus. I haven't talked to anyone who has taken a look at the impact that an adjustment to the X factors has on tax reserves.

Mr. Stephen M. Batza: Just to follow up on that question, I guess my sense of it was that it shouldn't affect your tax reserves much because the X factors just apply to the deficiency reserves and so they're not a tax issue anyway.

Mr. Pfeiffer: It's probably worth mentioning that the old version of XXX prior to what happened at year-end 1998 was adopted as a model; therefore, that was the accepted approach for tax reserves at year-end 1998. I don't know how many companies actually employed old XXX for tax reserves, but in theory that was the method. That's for the mortality and interest basis. The method is defined by whatever the NAIC method is.

From the Floor: With preferred criteria being out there for several years, how do you measure credibility of results? Is the SOA thinking about doing a survey of all the member companies to see if they can get a preferred mortality study done?

Mr. Klein: I think that the survey is really hard to do for preferred because the different classification approaches really make a difference. It's not just if you should throw everything into preferred class, but we know there are companies that call their standard business preferred and it's just really difficult to do an overall study in my opinion. Now I don't know if SOA is aiming to do something like that.

Mr. Allen M. Klein: The SOA is trying to conduct a mortality study, but it's not really a preferred study. It's going to be a study of all insureds. What we're doing is we're taking a look at all of the criteria that's used in the underwriting decision for preferred, compiling a huge database so we can slice it and dice it any which way we want. We're hoping to start collecting data this year, although we realize with the Y2K issues that may not be until next year. We're hoping to start collecting data as of 1998 issues going forward so it's going to be a few years before we have enough data, but we're looking to make this a huge mortality study and I think in time it's going to replace pretty much all the mortality studies that we do because it's going to be all encompassing.