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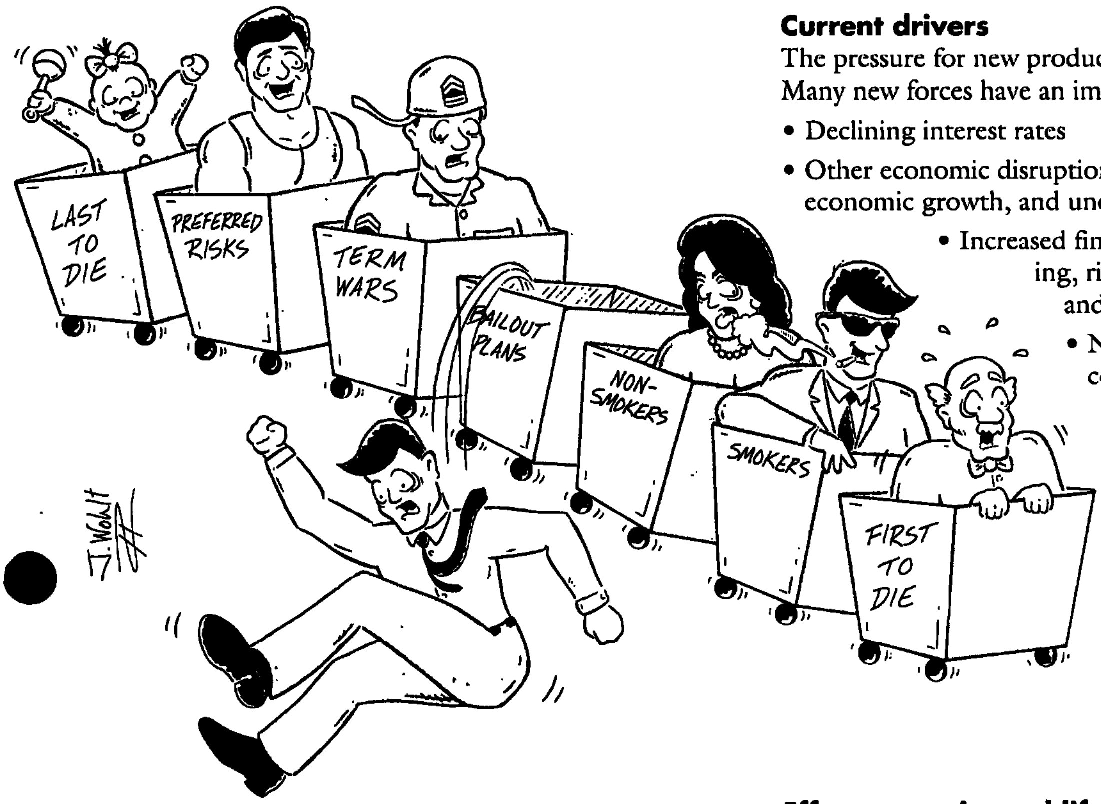
Riding the life product rollercoaster

by Charles E. Ritzke



My career started in the mid-1970s. Life products sold then had, with minor variations, been around for a very long time (1958 CSO created the last flurry of new activity). However, soon the onslaught began: nonguaranteed deferred annuities, adjustable life, new dividend options, economatic par products, indeterminate premium plans, term/annuity sales, nonsmokers, preferred risks, term wars, first generation universal life, revertible term, indexed plans, fixed premium universal life, single premium universal life, short-term guarantees, long-term guarantees, bailout plans, illustration war bonuses, second generation, third generation..., universal life, bigger illustration war bonuses, MEC savers, accelerated benefits, last to die, first to die, universal term, still more bonuses (we really liked bonuses), and on and on.

This article is my perspective on the overarching drivers of current and future trends. Since this is only my perspective, readers are encouraged to add their insights.

Current drivers

The pressure for new product development has not let up. Many new forces have an impact:

- Declining interest rates
- Other economic disruptions (junk bonds, real estate values, economic growth, and unemployment)
- Increased financial oversight (cash flow testing, risk-based capital requirements, and rating agency oversight)
- Net shrinkage of internal industry competitors (company insolvencies/instability, mergers, acquisitions, streamlined company market focus, and rating downgrades)
- Increase in external industry competitors (banks and mutual funds)
- Rapidly changing markets (aging baby boomers, for example)
- Consumerism
- Taxation

Effects on universal life

As interest rates decline, most companies are finding it more difficult to market profitable, competitive, and financially viable universal life products. The current environment exposes the following basic flaws in the product's design.

The product became popular because of the enormous tax advantage in using the inside buildup of interest to pay for net insurance benefits. With high interest rates, this advantage was more than enough to offset the disadvantages of high distribution costs, premium taxes, and deferred acquisition cost (DAC) taxes. As interest rates declined, the tax advantage shrank while the disadvantages remained the same or increased.

Pressures increased to replace this advantage. For a time, this could be accomplished through investments with cash flow risk (junk bonds, real estate, and duration mismatch). Problem investments, insolvencies, and increased financial oversight, however, effectively blocked this approach.

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Life products (continued)

The search for alternatives to maintain the advantage led to "illustration wars." Many products were sold with over-optimistic nonguaranteed bonuses and other lapse supported illustration enhancements that will be difficult to support if lapse rates aren't high enough.

Back to traditional cash value products?

When interest rates started their decline, many traditional products with a strict portfolio (vs. new money) interest crediting strategy had an artificial but temporary advantage. The advantage was artificial because the companies still were attracting new money at a loss. Many looked at the deterioration of universal life as a signal of the return of traditional whole life products with their certainty and guarantees. However, most flaws described here also apply to traditional cash value products.

Trends toward selling insurance

More focus on competitive term products, deeply discounted preferred risk rates, aggressive insurance cost guarantees, insurance-oriented universal life products (e.g., universal term), and new insurance benefits (e.g., accelerated benefits) is the response to all the drivers. When under attack, focus on what you do best or on what the external competitors don't do at all.

Annuities

While fixed deferred annuities have the same or worse cash-flow risks, they don't have several of the disadvantages of cash value life products. Distribution costs, premium taxes, and DAC taxes usually are much less for deferred annuities. I haven't done a detailed comparison, but I'd wager that a convincing argument could be made for the advantages of a competitive term plus annuity package over the most competitive of cash value life products, with the term benefit boosted to pay the tax at death.

Variable and modified guaranteed products

These products address the desire to replenish the lost advantages of higher interest rates and the problem of external competitors. How well will life companies compete? How will popular mutual funds combined with competitive term, boosted to pay taxes at death, compare to variable life?

Market segmentation, target marketing, and data base marketing

More attention is being given to disciplined approaches to marketing. Customized niche products, services, risk classification, and distribution methods are being developed that focus on identifiable, homogeneous customer groups. If done well (it's not easy), reduced distribution costs can create new competitive advantages.

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Drivers for the future

I believe the following four factors will be the primary drivers for future product trends:

- Interest rates and other economic factors
- Solvency concerns
- Taxation
- Insurance regulation

Interest rates and other economic factors probably will continue to have a major effect on product trends. A future interest rate spike will create another round of pain for some and short-term opportunity for others.

Increases in individual tax rates will increase the relative tax advantages of cash value products. The continued search for increased tax revenue, however, likely will add offsetting elements to the equation.

I believe insurance regulation will be a major determinant of future product trends. If we are ever to get off the product development roller coaster we've been on, we need to push for enlightened regulation of future life products. Valuation laws, nonforfeiture laws, illustration regulations, and other consumer protection initiatives all require bold and creative approaches that go beyond the current political and adversarial atmosphere. We need regulators who will be open to new ideas that recognize the realities of the marketplace. We need regulators who will foster an environment that encourages companies to compete responsib with an opportunity for profit.

Life insurance companies also need to cooperate in an unbiased, unselfish manner in responding to the regulators' needs to protect consumer interests and company solvency and to maintain a level competitive playing field. I think that actuaries on both sides of the fence are best able to take the initiative here.

The current product development environment is one of defensive posturing and unsatisfactory compromises. If we can create the proper environment, however, product actuaries can focus their future creative efforts toward a more customer-oriented marketing effort that will benefit both consumers and the life insurance business.

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