TRANSACTIONS OF SOCIETY OF ACTUARIES
1956 VOL. 8 NO. 21

PREMIUM DIFFERENTIALS

A. Is gradation of premium rates by policy size feasible or desirable? How can it be done in view of state laws now on the books? Has any model legislation been proposed to permit it?
B. Is it practical to give lower premium rates to females? What problems are encountered and how can they be met?

MR. W. D. KIDWELL emphasized that gradation of premium rates by policy size had been operated quite successfully for a number of years in Canada and England. Calculations made at the Paul Revere indicate that for a whole life policy issued at age 20, the variation in premium would be as much as $3.00 per thousand in going from a $2,000 policy to a $15,000 policy. On this basis it appears to be practical to adopt gradation of premium rates by policy size.

In theory this arrangement is desirable because it would assess the costs of acquisition and maintenance on a more equitable basis and would also eliminate the odd-plan specials which have become so prominent recently. From this standpoint it would eliminate a number of headaches which a small company may now have.

It would appear, however, that in view of the antidiscrimination laws it is unlikely that approval will be granted in all states for some time. To overcome this difficulty the companies can continue to use odd-plan specials or they might offer some sort of package plan for policies in very small amounts, for example, under $2,000. Another possibility would be to cut out smaller policies entirely by setting a minimum size of issue for every policy. Still another possibility might be to offer a full program of policies on a class minimum basis. To illustrate this, there might be a $1,000 minimum class which would include policies with a long premium paying period to be used for burial purposes, along with one or two endowment forms for small savings and educational purposes. A second group might consist of those plans properly issued for business and these would be offered with substantial minimums of $15,000 or $20,000 and would include such plans as a whole life policy together with reducing term or renewable term. The third group of policies would be the intermediate group where the bulk of the policies are now sold. This group would embrace the popular life plans, endowment plans, and retirement income endowment policies.

Another possible method would be to adopt the British system of policy fees, but so far there has been no formal approval of such a system in the United States.

Turning to the question of lower premium rates for females, Mr. Kidwell stated that there were four or five companies that are presently employing this practice. One reinsurance company in particular has been reducing the age for females by three years. So far as the Paul Revere is concerned, this procedure does not appear to be practical at this time because of the small average size policies on females.

MR. G. F. KNIGHT stated that the Berkshire Life, in making plans for its new rate book in February 1956, decided to adopt gradation by size if approval could be obtained from each of the states in which the company operated. In March 1955 they approached each of their state supervising authorities outlining the proposal to offer for each plan of insurance three classes with premium rates varying by class. The first class would be policies under \$5,000, next policies of \$5,000 to \$12,500, and finally policies of \$12,500 and over. Part of the plan was that nonforfeiture values and dividends in the three classes would not vary. The differential in premiums would arise solely from the method of spreading the per policy expenses, that is, no difference in underwriting selection was involved.

The company was much encouraged when the New York Department answered with its important ruling of April 27, 1955; unfortunately all of the states did not agree with the principle so that the company was unable to adopt this principle in the new rate book.

Eight of the states in which the company is licensed definitely approved the plan but four others have strongly disapproved. The antidiscrimination statutes of the states generally follow a common pattern, that is, that discrimination between rates in policies "of the same class and equal expectation of life" is prohibited. Although there is a difference of opinion among legal authorities as to whether this applies to business written outside of a given state, the general feeling is that if such statutes apply at all, they apply everywhere.

The matter was referred to the Special Policy Subcommittee of the Life Committee of the NAIC. After hearings held by it, at which no testimony in objection to the plan was offered, the subcommittee came up with a masterful report which was adopted by the NAIC at its meeting in St. Louis last week.

The adoption of the report was unanimous and the following paragraph from the report is of particular interest:

> It is important to remember that discrimination by itself, namely, treating one person differently from another, is not forbidden. What is forbidden is "unfair" discrimination or treating differently persons of the same class under the same circumstances. The division of risks into different classes must not

be arbitrary but must be for some reasonable purpose. A reasonable purpose supports the proposed classes of premium rates, graded by amount of insurance.

The subcommittee's recommendation was as follows:

It is in the best interest of the insuring public to recognize that life insurance companies, which desire to do so, may graduate their premiums or dividends by policy size for the principal plans of insurance, subject to the responsibility on their part to show that any system of groupings of premium rates or dividend classifications is reasonable, equitable, and nondiscriminatory.

Mr. Knight added a further word of caution, stating that it was necessary to take into consideration the proportion of a company's business falling within the proposed size groupings. The gradation of premium rates by size tends to increase premiums on policies for lower amounts and if a very substantial proportion of business falls in the lower bracket care must be taken that the company does not price itself out of its market.

In conclusion, Mr. Knight felt that the encouragement given by last week's action of the NAIC would open the door for the gradation of premiums in the near future.

MR. W. M. STEWART emphasized that he, too, felt that gradation of premium rates by policy size would be feasible in the very near future. He emphasized, as Mr. Knight had, that for a company writing predominantly policies of small average size there could be some question as to whether the company should adopt the scheme of gradation.

He also pointed out that the gradation of premium rates by size would give some agents additional trouble in determining the proper premium to be charged and there was some suggestion in mortality statistics that policies written for larger amounts have higher mortality; moreover, the cost of underwriting for larger policies is normally more expensive than for smaller ones. Additionally, larger policyholders demand more in the way of service, for example, in future changes of plan and in greater use of settlement options.

Turning to the discussion of special rates for women, Mr. Stewart stated that at first glance this would appear to be the logical thing to do. In a number of areas, such as disability rates, retirement endowment policies, and special settlement options, this differentiation has already been made.

On the other hand, he stated that there are a number of practical aspects to this question which may outweigh the theoretical considerations. Usually the policies involved are for relatively small amounts and the present system of premium calculation is complicated enough insofar as the public is concerned.

If a special series of rates is to be adopted, Mr. Stewart felt it should be a relatively simple modification of the corresponding rates applicable to males. It would be more feasible for a large company to adopt such a program than for a small one. If, however, the large companies adopted the idea, the small companies would probably be forced to follow.

MR. J. F. HOOK suggested that the feasibility of gradation of premium rates by policy size would be affected by the attitude of the public. The following factors give some hint as to the probable public acceptance:

1. There is widespread acceptance of "special" policies of minimum size.
2. Recent developments in the group field have included the writing of large amounts on individual lives. Buyers of such amounts are apparently willing to sacrifice the stability and security of permanent insurance in order to avoid the large overhead costs which go with it.
3. The "buyer is king" is the philosophy of present marketing of other goods.

These three items indicate that the public, especially the buyers of large amounts, will eagerly accept gradation of premiums by size.

Other factors to be considered are that at present gross inequities exist between buyers of insurance on different plans. Today, the insurance buyer may obtain ordinary life insurance or term insurance with a premium reduction because of amount, whereas the same privilege is seldom available to him on endowment plans, although it is obvious that expenses per $1,000 of insurance reduce with average size of policy.

The factors discussed above all support the feasibility and desirability of gradation of premiums by size of policy. On the negative side is the fact that the cost of insurance for small policies will increase, variation by size will result in increasing competition between companies, and rate schedules and insurance operations will be more complex.

Generally speaking, it would appear that the positive arguments outweigh the negative. Mr. Hook also mentioned the importance of a smaller company examining the market to which it sells to see whether it should logically decide to grade premiums by size.

Speaking about the possibility of lower rates for females, he stated that, with gradation of premiums by size of policy, lower premiums for women become more practical and the natural way to provide the lower premium is by means of an age differential, such as is used for annuities. The probable range of the age difference will be from one to three years.

MR. C. J. STAFFORD stated that the Monarch of Canada had begun grading premiums by size on January 1 last. Prior to this gradation

65% of their issues were $2,500 or less and a large proportion of these were juvenile. The company is active in rural areas and the gradation of premium rates was made to help to develop a more competitive rate situation for urban business.

On January 1 the new series was introduced with varying premium rates for the following classes: on policies from $1,000 to $2,999 the premium is $2.25 higher than the next class which runs from $3,000 to $9,999 on which premiums are $0.75 higher than the next class with a minimum amount of $10,000. Since the introduction of these graded rates, the amount of insurance under $3,000 has decreased from 65% to 35% by number and the business over $10,000 has quadrupled from 3% to 12%; over-all business has increased 30%.

In Canada there is no deficiency reserve problem to worry about and some premiums in the new series may be below CSO 3%. Mr. Stafford suggested that perhaps the companies writing a large share of small policies would benefit greatly, as had his company, by grading premiums.

MR. H. M. SARASON agreed with the observations of Mr. Stafford, stating that he felt that the companies should encourage their agents to write larger policies. He stated that a minimum policy of $1,000 a few years ago was about the same as a minimum of $2,000 or $2,500 now. In his view there is no economic justification for a great many of the sales to adult males in amounts of less than $2,500.

Mr. Sarason suggested that so far as females are concerned a lower minimum size for females would be justifiable at the same rate basis. Alternatively, he suggested that the disability premium for women might be made standard and give the women some credit for their better mortality in this fashion. He also pointed out that women tend to have higher persistency than men and this is perhaps more important than the 20% decrease in mortality associated with women; moreover, since fewer women will be beneficiaries in the case of policies written on the lives of women, the adverse selection on settlement options would be less on these policies.

MR. R. E. EDWARDS felt that the NAIC action was extremely significant but that in some states, as in New York, the existing legislation provided sufficient latitude. However, it might not be the law, but the viewpoint of the person having the duty to interpret it, that could create a problem in connection with graded premiums.

If some companies were to set their premium rates at an unjustifiably low level for large amounts of insurance, they would need to compensate for it on small amounts of insurance by charging premiums that were somewhat higher than justified by the underlying expenses. Such action, in view of the fact that the smaller amount market has the greater total potential sales volume, would greatly enhance the competitive position of combination companies, such as his own, whose agents are closely allied with policyholders who, having lower incomes, are apt to buy policies of smaller amounts. Consequently he expects competition to bring grading into line with reality.

He felt that the difference in premiums between male and female risks was so substantial that it would be incongruous to use differentials by amount of insurance and not by sex. The solution, although details need to be worked out, might be the use of lower amount brackets for females than for males.