Market Conditions Affect Term Pricing

The current economic crisis is challenging life insurers to look closely at all of the products in their portfolio and make adjustments as necessary. While much of the focus is on variable annuities and universal life with secondary guarantees, the performance of term life is also affected by market upheaval.

In this issue of the Forecaster, Jim McArdle, Senior Vice President of Sales and Marketing, discusses the impact of current market conditions on term life insurance with Keith Dall, Principal at Milliman, Inc. Keith sees companies responding in a variety of ways – looking for new financing solutions, tightening underwriting guidelines, monitoring products and rates more closely and more.

Keith joined Milliman in 1998. He frequently presents at industry meetings and writes for industry publications on a broad range of topics. Prior to joining Milliman, Keith was chief actuary for American States Life Insurance Company. He received his Bachelor of Science degree in Mathematics from the University of Southern Indiana.

**Market and Financing**

**Jim McArdle:** In view of the financial crisis and its impact on capital markets solutions, do you expect to see repricing by more term writers in the near term?

**Keith Dall:** It is a little early to see changes in the premium rates themselves, but companies definitely are assessing the impact that current conditions, including financing costs, have on their products. I think capital management solutions are a big concern for the larger carriers. Certainly they’ve been pricing fairly small financing costs in their products for the past few years. Now, with the change in the economic environment, they no longer are able to get the financing costs that they used in their pricing. The fact that they’re actively looking for other solutions, be it banks or hedge funds or reinsurance, shows that reserve financing is at the front of their mind. Companies are scrambling now with a lot of different challenges, but this is certainly up there among many other issues. And down the road, if new financing solutions are not found, I think you are going to see large carriers start to increase their rates.

Already we see closer monitoring of and adjustments being made to specific pricing cells. This has become a big issue for term writers, especially given how easy it is for independent brokers to find the lowest term rates in the market. A poorly priced cell creates a hole through which companies can be selected against, and this can really damage the profitability of a term product.

**JM:** The importance of term life in a company’s product portfolio varies from carrier to carrier. Do you see companies questioning the ‘fit’ of the term product itself?

**KD:** To the extent that companies are questioning their product line, they are looking much more closely at annuities and UL with secondary guarantees than their term product. Normally, the way a company views a product – as a profit driver or more of a loss leader or niche product – evolves over time. I don’t see major product shifts occurring at this stage, but companies certainly are beginning to evaluate the impact each product has on overall results.
Mortality and Underwriting

JM: Do you think companies are pricing mortality aggressively in order to offer competitive term rates?

KD: I would not say they are pricing aggressively, but companies certainly do not leave much, if any, conservatism in their mortality assumptions. More and more companies are looking at their underwriting process, guidelines, their own culture and distribution in order to get the best mortality in the door. That said, I think companies need to monitor ongoing product performance more closely to make sure expected and actual mortality are in alignment. As an industry, we tend to price our products, get them out the door, start selling and then move on to the next product development project.

JM: We’ve observed companies with similar characteristics – product features, target market, distribution, underwriting guidelines – experience very different mortality results. Do you see these differences?

KD: Yes, I do. With the work we have done on securitizations over the years, one thing that has surprised me is that very similar companies develop fairly different expected mortality rates. I think this shows that mortality is influenced by a number of things not just underwriting guidelines. Maybe it’s the underwriting culture within the company, the pressure to increase sales or maybe it’s the claims investigation. It could be a variety of issues that are impacting expected mortality.

JM: Do you see companies changing their underwriting guidelines and then running into problems getting the hoped for results?

KD: This can happen with simplified issue products where companies are dealing with fewer underwriting tools to begin with so changing one thing can have a proportionally bigger impact on results. There has not been a lot of protective value work in the industry on simplified issue underwriting, which is why companies need to monitor this business closely and why we have seen the competitiveness of certain companies change over time. Also, little of this business is reinsured so companies don’t have the value of that perspective.

At the higher end, with fully underwritten products, companies are tightening up their preferred underwriting guidelines to improve results. They’re doing this in part to lower expected mortality and support lower rates or even to justify current rates. They are also doing it because reinsurance rates have not been reducing as quickly as they had been in the last few years. In order to lower rates or even justify the rates they have, companies are tightening up preferred mortality requirements like cholesterol count and blood pressure.

JM: The growth of the older age market presents new opportunities for life insurers. Besides demographics, is the settlement business also driving the growth?

KD: For term life, I think the growth of older age business is largely due to the demographics. This product is not affected much by the secondary market. However, companies do need to be careful that life settlement brokers do not take advantage of the length of their conversion periods.

By contrast, for UL with secondary guarantees, there is no question that some of the growth in older age business is due to life settlements, and companies are very concerned about this. In recent years some companies have started pulling their UL/SG products at the higher ages.

Also, there has been a good deal of commentary in the industry press that could be discouraging the sale of accumulation life products to older age applicants. It’s possible that this trend is helping to drive an older age applicant to term life as an alternative.

JM: Do you think any of the new underwriting tools for older age applicants demonstrate protective value?

KD: Virtually every carrier we have talked to is working to improve the competitiveness of their older age products. Developing better tools to underwrite to higher ages is part of that process. Some
experts believe that cognitive testing, which has been used in the long term care market for obvious reasons, offers an underwriting benefit at older ages. I know that some larger companies are actively using it. The theory makes sense. It certainly seems like the additional underwriting would help, but I am not aware of any company having enough experience to do a credible mortality study at this stage.

Lapse

**JM:** What are your thoughts on current lapse assumptions for term products?

**KD:** I think there are some lapse risks out there that companies should be concerned about, for both lower- and higher-than-expected lapse rates.

For the last few years, most term writers have seen their lapse rates decrease — a reversal of an earlier trend toward higher lapse rates. For several years, low cost reinsurance enabled term writers to lower premium rates, which gave agents a reason to encourage policy replacement. Now that reinsurance rates have steadied and direct writers are taking a harder look at their own profitability, premium rates are flat and lapse rates have fallen.

The current economic environment presents a totally different issue. Going forward, lapse rates won’t be driven by premium rates as much as by policyholders potentially being unwilling or unable to make payments. With the unemployment rate increasing dramatically, insurers are going to see some impact on lapse rates for all their products. The length of the recession will determine the magnitude of the impact on lapse rates.

Lapse rates can be a mixed bag from a profitability standpoint. For return of premium products, a company that priced for higher lapse rates than what the industry was seeing may actually benefit from rising lapse rates. Of course you would want those lapses in the later durations, and most ROP products have not been out there long enough to be able to monitor the experience in the later durations.

**JM:** We are just now getting shock lapse experience for the first wave of 10-year level term products. Are companies making out better or worse than expected?

**KD:** The early studies show that shock lapse rates have been lower than industry expectations. Ten years ago, companies were pricing in a 100 percent lapse assumption at the end of the level premium period. It has only been within the last decade that companies have allowed for some profitability after the level term period and began assuming a shock lapse of less than 100 percent with a loss ratio of expected benefits paid to premiums received to be less than 100 percent. So it will be interesting to continue to monitor the experience over the next few years.

Also, preliminary results show that actual mortality is fairly high in the 11th and 12th durations, but more experience is needed to reach a definitive conclusion.

Regulation

**JM:** Circling back to the capital markets and XXX reserve funding, what permanent solutions might help term writers over the next 12-18 months?

**KD:** I don’t see anything on the horizon that suggests itself as the next capital markets solution for direct writers. I’ve worked on a few deals where companies were looking into specific capital solutions. Unfortunately, getting creditors comfortable with the risks is a very difficult process, especially in today’s environment. One thing that could help the situation for direct writers is principles based reserves, although that is a few years away.

**JM:** The NAIC recently rejected an ACLI proposal for uniform rules for capital and reserve relief. Do you think state initiatives will create competitive advantages and disadvantages?

**KD:** It’s certainly a possibility. It only takes a few states implementing new reserving guidelines to create an uneven playing field. However, I think that most individual commissioners will prefer to wait for further guidance from the NAIC, now
that it has ruled against uniform guidelines.

Term life products might conceivably receive relief from the NAIC sooner than later. Everybody is aware there are redundant reserves for term, and it seems like a good place to start giving companies a break from their balance sheet issues. However, I think the NAIC has difficulty separating XXX reserving issues, because they are looking at solvency from a total company perspective. I guess we will see how that plays out.

**Looking Forward**

**JM:** Any thoughts on the overall level of term insurance sales in 2009?

**KD:** I think it’s going to be a difficult year sales-wise since people have less money to put into life insurance products. Term product lines will probably do better than some of the accumulation products and long-term products with higher premiums, just because of the amount of money that people will be willing to spend on life insurance.

I think there will be winners and losers. Insurers that have had unfavorable asset quality or mortality experience will probably have to increase their rates, and their sales will decrease significantly. Other companies will probably have trouble succeeding in the highly competitive term market. A weakness in any one area, be it sales, lapse rates, asset quality, mortality or expenses, can impact profitability and therefore a company’s competitiveness going forward.

But there are a lot of companies out there that have done a tremendous job of monitoring their business and underwriting to bring in a good pool of risks. These companies should see their sales at least stay level and maybe even increase.