Preferred underwriting has helped direct writers segregate favorable risks from those less than favorable and using an expanded standard class has helped companies compete in the marketplace. However, the mere presence of these programs introduces new risks into the underwriting process.

Michael Colannino, Transamerica Reinsurance’s Senior Vice President of Life Solutions, recently discussed the topic of preferred underwriting with Rick Bergstrom, Senior Partner in Milliman & Robertson Seattle offices and a member of the Preferred Underwriting Task Force of the Society of Actuaries. Rick highlights how to set and manage underwriting standards. He discusses further the issue of exceptions, concluding with a look at what the future may hold.

Rick received his bachelor’s degree in mathematics and physics from Iowa State University. He is a Fellow of the Society of Actuaries and Member of the American Academy of Actuaries.

Michael Colannino: Do producers anticipate companies’ underwriting behavior and select against various insurers? And what can an insurer do to protect itself from this anti-selection effect?

Rick Bergstrom: Absolutely. Companies are targeted, there’s no question, particularly the companies that allow brokerage business. Companies with table shaving programs are targeted. If a company has a table-shave program that is more liberal than someone else’s, they will get the Table 4 and 5 applicants there.

The only way to really protect yourself is to do your underwriting well. If you priced for accepting 10 percent in your table-shave program and you get 20 percent, you need to tighten it up.

But the basic answer is, yes. Producers have their favorite companies. They know who’s more liberal in heart disease questions or blood pressure or table shaves. And even though they may be very minor liberalizations they nevertheless can have an impact on mortality.

MC: Aside from pricing what other risks are associated with exceptions and table-shave programs?

RB: The risk of consistency. A company, even if it prices for exceptions, is making certain exceptions for certain impairments or disqualifications, but if they’re not
consistent in what they do, they run the risk of opening themselves up to a potential class-action lawsuit down the road.

So underwriters need to have their own internal audits that ensure they are making consistent decisions when they have exceptions, and even when they don’t.

Now, consistent doesn’t mean it has to be 100 percent. But it can’t be 90 percent in my mind. That translates to too much inconsistency. It really comes down to accountability. I think we all recognize the word, but I’m not sure all companies know how to police themselves that way.

**MC:** Are companies seeing the mortality that they priced for?

**RB:** It’s really a mixed bag - some companies are and some aren’t. The real test will be when companies have at least ten durations of experience and they can track their slopes, particularly after durations 3-5.

**MC:** Let’s discuss some of the critical factors driving profit of preferred portfolio. Are direct companies aware that their underwriting is liberal or conservative and price accordingly?

**RB:** Certainly from an underwriting guidelines perspective, companies know. They conduct their own comparisons and the results are published, and the agents do it if the companies don’t. So people are aware of what differences are there.

**MC:** Because of the nature of people, some people will migrate from preferred to select and vice versa. However, companies can only underwrite once. Does preferred wear off?

**RB:** How long that select period lasts no one really knows, but I think if companies are actually pricing properly and classifying properly, those levels will remain constant for a fairly long time. But will they converge? Yes they will, eventually.

**MC:** How does the lapse rate affect the wearing off of preferred?

**RB:** Lapses have quite an effect. If you get very good persistency, I think that relative differential between classes is going to be pretty constant for some time. If your lapse rates are 10-12 percent, you’re losing your good people either for a better rate or for some other reason. But the remaining bodies are going to develop a different risk class profile just within that same class.

**MC:** Do mortality tables reflect some of this?

**RB:** I don’t think they really do. There’s a built-in persistency factor already in the studies that we do for the SOA. If a company’s persistency is better than what’s in the study itself, you should expect it to have better mortality. But to my knowledge, nothing is actually built in.

**Managing Reality to Meet Expectations**

**MC:** Companies that have literally the same number of classes, the same criteria, the same risk points send in their mortality studies with very divergent results. What could account for these differences?

**RB:** There are actually a number of things. One is the company’s actual market. The profile of individual applicants could be different. And clearly distribution systems have a lot to do with this. If you’re a brokerage company, you’ll get a different mortality than if you’re a company that has a captive field force.

In addition, companies, even with the same requirements, have different percentages of people classified in a certain risk class. Some companies may be more liberal in making their business decisions or their exception rates.

**MC:** With the shift to first-dollar quota share (FDQS), how has underwriting discipline in direct writers changed?

**RB:** I think the underwriting community historically has been good at maintaining what they’re told to do. What they develop, they try to do. Now, of course there are exceptions, business decisions, agent issues. This isn’t a perfect world, and sometimes the pressure from producers to make exceptions can trump the integrity of the underwriting process.
MC: Can an insurer sustain liberal underwriting with competitive pricing?

RB: In the short term, this may be very possible. But sooner or later this dangerous cocktail will catch up with them, and the fallout will not be particularly pleasant.

Fallout will arise from one of two sources. The more likely source will be the market itself: as producers recognize this as the company’s practice, they will be targeted more and more for business that would not be accepted at other companies.

The other possible source of fallout is the company’s reinsurers. The reinsurers will be looking closely at the actual-to-expected business performance, and it won’t take long for them to discover that there is something wrong here. The consequences from this disagreement could be pretty dire, possibly leading to the reinsurer denying claims.

MC: What metrics would you examine to determine if a company was underwriting liberally and pricing competitively?

RB: The first spot I would look at is their actual-to-expected placement. Are they placing 40 percent of their cases when they expected only 25 percent to qualify? If so, there could be a problem.

Another ratio I would look at if I were an internal auditor is the percentage of cases that qualified with three or more borderline requirements. The composition of the risk class should be centered toward the middle of the thresholds, not leaning toward the upper end, and companies should really track this.

Companies also need to track what people are dying of and not just the number of people dying. Did we miss anything in the underwriting process? The results need to be factored into their pricing going forward, or they’re going to suffer later on.

MC: What are your thoughts on reinsurers tightening what can be considered an acceptable exclusion or shaved application, even including these terms in the treaty provisions?

RB: I think that’s the proper procedure. There are some companies with exception rates of 20 percent or higher. There are some companies with exception rates of virtually zero. Everyone is going to have the occasional exception.

So before you make a decision, you need to find out how this is really going to affect the business, including the reinsurance relationship. I’ve seen applications going from a Table 4 to a preferred as a business decision. In some cases it’s not even a table-shave. It’s an error. That’s bad judgment.

Managing Exceptions

MC: When is an exception no longer an exception?

RB: An exception to me is one where it’s a borderline case and maybe the underwriter is stretching his decision by allowing extra credit for a certain positive event or threshold, but it’s not something that’s going to be a mistake by more than 20 debits or so. If it’s more than that, then it becomes a business decision. Business decisions, in my mind, should not be made by one person but by at least two, and one of those should probably be the medical director. Reinsurers should also be consulted.

MC: Do companies price for their considering an exception policy?

RB: I don’t know anybody who prices for exceptions. I think they price assuming there are no exceptions, even though they know there will be some.

MC: What might be an appropriate exception rate that a product line manager could be comfortable with?

RB: I would say no more than two percent.

MC: What is the acceptable degree of stretch in an exception policy?

RB: I think no more than 20 debits unless there were some positive credits also present. But this should not be published nor even considered unless an agent requested it. Incidentally, exception rates should be tracked by the agent and the underwriter.

Continued next page
As insurers and reinsurers explore new avenues of risk and capital relief, "quality" has become the buzz word. This certainly applies with underwriting today: demonstrable quality in underwriting is more important than ever before as the number of stakeholders has expanded from the traditional reinsurer to ratings agencies, monoline insurers, and the investment community at large.

What makes managing underwriting even more difficult is the need for the insurer to remain competitive in an ever evolving market, especially with respect to term life. This requires the insurer to actively manage the balance between liberal underwriting and competitive pricing. The company's actuaries can help determine how underwriting practice can affect the performance of a block of business.

Reinsurers are also in a good position to advise clients on underwriting practices and guidelines. It is, after all, in the best interest of both parties that the performance of a book of business mirrors the expected returns as closely as possible. However, reinsurers merely wish to consult on the underwriting decision, not actively manage it. This is yet one more facet to managing the insurer-reinsurer partnership.

We at Transamerica Reinsurance always stand prepared to work with our clients in determining the correct risk classification system for customers. Demonstrated underwriting integrity helps ensure the greatest access to reinsurance solutions under the most reasonable terms.

MC: Regarding preferred underwriting criteria, are you seeing any convergence of the numbers of classes or the thresholds that will get you in a particular class?

RB: I think they are honing to the average, which is a three non-tobacco and two tobacco class system. The four-two is still popular, but there are less of them than the three-two. The problem with having four or more is that as you keep slicing and dicing, what do you have left?

Brokerage companies want the 4-2 because they want their price break at the top end. And they may get 50-60 percent in their best class because they've got the best rate. Did they price for that? No, they didn't. I did an audit for a company a couple of years ago with a five-class system, and their two best classes had 85 percent of their business.

MC: Do you foresee a change in the definition of preferred risk for the more affluent customers?

RB: Not for the majority of adult ages, but you could see some change for the 70+ age cohort. I don't think companies can support a four-class system above age 70, or even a 3-class system above age 80.

Also, requirements for geriatric underwriting will need to be reviewed and modified to fit the profiles of truly healthy seniors. For example, I have been told that very low cholesterol levels are not really healthy, but a bit of blood pressure elevation is not necessarily bad, all other things being constant. Application questions should also – and will – be fine-tuned.