The Future of Underwriting

Donald M. Haskins, M.D.
Executive Vice President
General Reassurance Corporation

An address given at the 93rd Annual Meeting of
The Association of Life Insurance Medical Directors of America

In recent column by *James Reston* in the New York Times, where he was discussing strategic planning, objectives and deeper meanings, he quoted *Conrad Hilton* who in answer to the question "What had he learned from his long life as a Hotelier?" said, "I've learned that it is better to keep the shower curtain within the tub". So it is in my relatively short span as an underwriter, I have learned that it is better to keep the actual loss ratio within the expected loss ratio. This short homily underlies my thought process on the future of underwriting. Remember, I am going to talk about the future of underwriting, not underwriting of the future.

First, let us consider where we have been. Then let us consider where we are. Look back over the past quarter of a century. Twenty-five years ago lapse rates were predictable. The Linton Tables were constructed. Interest rates were at a 3-4% level. Risks were assessed at higher than the expected results. Companies made money on their underwriting. The medical scene was rather quiet. The era of decreasing population mortality from the discovery of antibiotics and various vaccines had passed. Mortality had stabilized. There was a quietness on the medical research and experimental surgical front. We had a father-figure for a President and all was well with the world - or was it?

The giants in the insurance industry were the actuaries, underwriters and the medical directors. I am certain the names Webster, Arnold and Sheppard conjure up folk tales of old. And Doctors Ungerleider, Getman, Pepper, Kirkland, Mathewson, Reynolds, Cochran, Wilson, Barker, Larson just to name a few, important people to the success of the insurance industry. Why important? Because underwriting results were one of the keystones of insurance profitability.

Through the early sixties there was not too much change in the status quo. Company underwriting staffs were entrenched. Medical Directors were an accepted part of the company and the risk selection process. Accepted and entrenched but few challenges were being offered to the established ways and few, if any, questions were being asked. A few substandard specialty brokerage companies were formed. However most of these companies failed because of the high expense of operations and because of the paucity of compatible reinsurance outlets.

Agency forces were mostly captive. The agents believed in their companies and believed in their companies' underwriting staffs. Management looked to underwriting as a very important profit center. Whole life made up 80-90% of the portfolio, term was not especially popular and generally was not offered if the applicant was greater than a 200% risk. This was a time when it could be said with a great deal of truth that if you formed a traditional life insurance company and got it up and going through the first five years or so, it was impossible for that company to fail.

Where were reinsurers during this time? They were operating, utilized when necessary, not dominant, looked to for service. Agents and brokers only knew they existed, they really did not know who they were. They were in the forefront of "experimental underwriting", helping the direct company on those unusual medical cases and utilized for capacity. Underwriting shopping, no one had ever heard of it.

Then the mid to late 60's, the 60's devastated America. Nothing will ever be the same again. And the spillover effected insurance. Three unrelated factors converged and interacted to make a profound change in underwriting, both in how it was done and in the calibre of who did it.

First Factor — New reinsurers migrated to the United States. These reinsurers were, at least the most important were, foreign imports. These were well-established conservative underwriting reinsurers who had been operating profitably for many years. Their question, how best to make inroads into the United States market? Through capacity? There was plenty of American capacity. Through financial treaties? Hardly, as these reinsurers entered on limited budgets. Financial treaties were expensive to create and the field was fairly well controlled by the domestic reinsurers. They, these foreign imports, saw the "soft belly" of the American reinsurance market. Underwriting - substandard underwriting, which in many respects was archaic and certainly conservative.

They picked their target - the substandard specialty brokerage companies looking for outlets; and their plan - aggressive substandard underwriting.

The Second Factor — The hallmark of the 60's -Consumerism, Nader style, full disclosure, down with the fat cat insurers, agent allegiance threatened, broker substandard experts, egalitarians being cloned.

And the Third Factor — And most important, something occurred which produced a steady, compounded improvement in population mortality.

How did these three factors interact to create such a profound change in underwriting?

The decrease in standard mortality rates seemed to give a legitimacy to aggressive underwriting, a legitimacy which spurred the reinsurers to new heights of aggressiveness (or should I say undisciplined foolishness). The consumerists looked at the profitability of permanent insurance, railed and hollered "buy term and invest the difference". And the ongoing problem of disintermediation (leaving one investment vehicle for another paying a higher current yield) began. Agent allegiance waned as their allegiance was turned towards the consumer. At first, agents bootlegged rated business to other insurers advertised as substandard specialists, then they became more overt in their business dealings, breaking down the company-agent contract.

Then in the mid 70's in the aftermath of the oil embargo, interest rates began moving upward at an accelerated rate along with spiraling inflation. Disintermediation became more flagrant and policy loans at the low interest contract rates became rampant. The liquidity problem became severe. These changes coupled with continued decreasing mortality had management convinced that the most important aspect of thier stewardship was asset management. They looked to tax planning for relief from the increasing taxable income due to high yields on their investments. For example, under the 1959 Life Insurance Tax Law, companies were taxed in several ways based on multiple financial factors. In general, however, mutual companies were taxed on investment income and stock companies on gain from operations. Using a modified coinsurance treaty written by a stock reinsurer, under section 820 of the Tax Code, mutual companies were able to change investment income to income from operations allowing profits rather than taxable income to emerge. Underwriting, as mortality kept improving, how important was underwriting?

At about the same time, a malignant, pernicious process, which had started in the mid and late sixties, gained momentum - underwriting shopping programs. These programs were spawned by the aggressive underwriting quotes of the reinsurers whose ranks now included the domestic reinsurers. Domestic reinsurers who had joined in the battle of low quotes in an effort to maintain their share of the facultative market. These aggressive quotes were picked up and fostered by self-interested agents and played upon by the consumerist. And management, in an attempt to satisfy their agents, actively promoted these efforts. In the beginning this change was not entirely pernicious, as questions were at least being raised and challenges offered to the established underwriting mores.

Then another happening occurred, generic Select and Ultimate Re-entry Term. Reams of articles have been written about this product, speeches made, fingers pointed at real, suspected or imagined culprits. But whatever else has been said, there is no doubt that this product helped produce the current crisis in the insurance business. When Select and Ultimate Term first hit the street, actuaries were adamant, underwriting had to be extremely strict, nothing could be given away, full underwriting requirements were mandatory. What happened as the rate war with this product progressed and premiums barely covered expected mortality? As there was no interest income, the only element in the product pricing assumptions where cost savings could occur was in the expense area. Therefore, underwriting standards were relaxed and requirements reduced and the terrible cycle was on its way.

Re-entry was an integral part of these products. First a fifth year re-entry with full medical information, obtained by the insured at his expense. Then full underwriting information at the company's expense; then a loosening of the requirements and a shortening of the time re-entry allowed; finally yearly re-entry with little or no underwriting requirements. And the rate war, pushed by the companies' empire fantasies and the consumers' enthusiasm, continued.

Aided by the reinsurers - you bet! Expansionist greed was evident there also. Before this annual renewable product appeared, term products were generally reinsured on a yearly renewable term basis (YRT). However, YRT reinsurance rates were higher in the early years than were the premiums for this cheap term. Because of this dichotomy reinsurers had to reinsure Select and Ultimate Re-entry Term on a coinsurance basis. Now in addition to the rate war on this poorly constructed product was added an allowance war by the reinsurance companies. As it developed both the primary insurers and the reinsurers committed an almost fatal miscalculation in the lapse and mortality assumptions used in the pricing of this product. Soon the allowances quoted to the primary companies were such that the insurers discovered they could make a profit on Select and Ultimate Term on the allowances alone.

What happened? Many primary companies cut their retention, passed more of the business to the reinsurers, along of course with the risk, and became more or less producing agencies for the reinsurers.

It was during this time that the results were first published on the mortality rates of smokers and non-smokers. With the much better mortality of the non-smoker, non-smoker discounts were added into the select rate of re-entry term. Was there a pitfall? Yes, how could anyone be certain that an applicant was truly a non-smoker? The answer, you could not. So non-smoking policies were issued based either on the applicant's word or non-definitive laboratory tests. What happened? What you would expect, the insurance applicant ratio of non-smoker to smoker was and continues grossly higher than the population figures.

How did the agent respond? His commission scale on Select and Ultimate Term was the traditional high first year, low renewal rate. Because of the extremely low premium, the agent could only make money by churning the policies. With the re-entry aspect of the policy, that is exactly what he did. However, with the rate war going on, the agent looked for the lowest first year rate among all companies. He started passing his client through multiple companies. That is, he passed everyone except the client whose insurability had changed, that applicant stayed behind. Obviously there was no reward to the agent for persistency, so lapse rates skyrocketed, 30 to 40 to even 50% renewal year lapses.

As previously noted, with the high interest problems, inflation and declining mortality, the underwriter lost his glamour and standing. Management turned towards financial and marketing personnel and their producers. These were the same individuals that demanded aggressive underwriting. In order to hold their producers, a standard quote on every applicant was essentially necessary. Where would or could they get the standard quote? From shopping programs! But by encouraging shopping programs management in fact allowed the reinsurers to determine their Company's underwriting philosophy. A circumstance which was certainly demeaning to their underwriting staff.

During this period of decreasing profits, management was compelled to look hard at expenses. What else could be done to lower them? As noted, underwriting requirements were altered. However, in any insurance company budget, what is responsible for one-half to two-thirds of the expense? Salaried personnel, and what professional salary was one of the "so-called" high tickets? M.D.'s!

Therefore many companies cut their medical staffs, in fact direct carnage was done to several of the large company medical staffs! Numerous companies went from full time medical directors to part-time medical directors. Why not, the argument went, M.D.'s in the underwriting process made their major contribution in the selection of substandard medical risks. Since the companies were becoming more and more dependent on shopping programs, leaning on their reinsurers, what was the necessity of expensive medical knowledge in their own shop? Lay underwriting staffs were also cut and training programs were shortened. What remained? First the medical director became in practical terms a pure medical consultant. And the lay underwriters were undertrained, understaffed and over "Xeroxed". The underwriting team was no longer one of a company's strong divisions, in fact, it became a division more to be tolerated than utilized. Generalizations on degenerating situations are not good as everyone is labeled, and some should not be. Certainly there were companies and underwriting staffs that fought this vicious underwriting trend, though the battle was never ending and was rarely won.

However, over the last two or so years something has happened to reinsurers' operating results. Something happened which may toll the death knell for cheap term and unreasoned underwriting. What were these events?

1. Insurance tax laws were changed. The well dried up on non-risk insurance profits and reinsurers had to look to other sectors for profits. Their eyes refocused on the ordinary life excess market, where instead of profits, losses were emerging. There was a crossing of premium and loss lines and especially if net of allowance premiums were analyzed.
2. Why the increased losses? Several factors were responsible. As reinsurers are especially affected by large amount cases, the most recent intercompany large amount mortality study graphically illustrates one of the reasons for the increased claim experience. That study showed a 10-15% differential in expected to actual mortality between term and permanent plans. A differential believed to be due to

selective lapsation and financial anti-selection. The cheap term product led to large face amounts, a $500 premium could buy a million dollar cover for a 30 year old. The *insured cells changed*. Million dollar policies were now being written on clerks and financial underwriting suffered, or should I say was ignored. No longer was this insured group a stable select group.

This was a group of insureds in turmoil, a mobile, plastic living group. I have alluded to the selective lapsation problem previously. With agents and brokers churning these policies, the healthy were moved, those with a change in insurability stayed behind, a no-win experience for the insurers and especially the reinsurers. There were the additional problems of conceptually poor underwriting and re-writes on limited underwriting. We created rather than indemnified estates.

3. *Most reinsurers are on GAAP accounting*. With skyrocketing lapses on Select and Ultimate Term, as well as lapses on permanent plans due to disintermediation, their deferred acquisition costs had to be written off more rapidly than expected. By doing this, current profits were drastically decreased and future profits could prove to be non-existent.

Reacting to these events, reinsurers began emphasizing persistency underwriting with level or contoured commissions on Select and Ultimate Term. While helpful the lapsation tide continued to roll in. Reinsurance allowances on these products were lowered in keeping with more realistic assumptions as to mortality and persistency and underwriting standards were tightened. And finally many in the reinsurance community pulled out of the cheap term market. Why? Well why promote bad products, products which if properly analyzed could be seen to be flawed from the beginning.

If no cheap term, what are the product lines of the future? We will always have term products, but hopefully at reasonable rates with commissions which are relatively flat or contoured to give a persistency initiative. Permanent whole life products will not disappear. A certain number of clients will always appreciate the forced saving feature. However, these products will not have the large built-in profit potential as did previous whole life products. Higher imputed interest rates with increased cash values will be a necessity - note excess interest and vanishing premium whole life products.

Single premium deferred and immediate annuities will continue to be useful products, after the clearing of the Baldwin debacle. Their usefulness in pension plans, IRA's and structured settlements has been amply shown.

But the most important products will be interest sensitive products. Variable Life had a renaissance during the stock market boom in 1982 and Universal Life in its numerous forms has exploded in the market. These are the products which have an appeal to the sophisticated buyer. They combine the protection of a term policy with a sheltered savings vehicle. The second generation of Universal Life, featuring the positive attributes of both a money fund and equity fund is very near fruition and promises to be an important product of the future as will flexible premium variable life.

Why have I spent so much time on the history of underwriting and life insurance product lines when I have been asked to talk about the future of underwriting? The reason, I hope, is clear. I believe the cycle is turning. We will be going from a very permissive insurance underwriting society to a more strict business instrument. Why, because once again management is *going to have to look to underwriting profits* in structuring their product lines.

Let us look at what happened to mortality from the early 60's through the 70's. Almost a 25% *drop in the age adjusted mortality rate!* But most important, where did those gains come from? They came from cardiovascular mortality improvements. In seeking an explanation for this decline in cardiovascular deaths and more specifically in ischemic heart disease, the question arises, has there been a decrease in events, or a decrease in the death rate subsequent to the event? Unfortunately, incidence data is lacking, therefore, no one knows for certain, a perfect example of what comes first, the chicken or the egg. Obviously, a number of factors come to mind which may and probably have altered the mortality rate of ischemic heart disease - bypass surgery, coronary care units, improvements in medical treatment, antihypertensive therapy, a leaner American through diet and exercise and a decrease in the smoking population. But as of now the mystery of decreasing mortality from ischemic heart disease in the magnitude we have seen remains unsolved.

Is it feasible to conclude that this 1.5 to 2% annual downward trend in mortality will continue indefinitely? Can we continue to count on declining mortality rates for product profitability? Unless you believe we will be a nation without coronary artery disease deaths and that the current research in oncogenes *portends a soon to be realized breakthrough in* cancer deaths, I do not see how anyone can predict the continuation of this degree of mortality improvement over any period of time.

With interest sensitive products, where will the pricing competition be? It will undoubtedly be where the glamour is, on the fund. A higher yield to the insured, with less retained by the company. I was recently told by the President of one of our client companies, that while they had assumed a GAAP profit of 100 basis points (1%) in the management of their fund, they were really anticipating a 150 basis points profit. However they were actually only getting 75 basis points profit. No, it seems obvious, companies will have to obtain reasonable underwriting profits on these products if the companies are to prosper.

The underwriting rate war seems to be slowing. Insurers and reinsurers are becoming more sensible in their ratings. There are less special "give away table" programs. The Underwriting Fairs put on by some of the very aggressive primary companies and supported by several of the reinsurers seem to have expired. Many reinsurers are now requiring that the primary companies retain a portion of each placed facultated case. The foreign market which was severely wounded by American business facultated or brokered to them, has now dried up for many of the more adventuresome primary companies. And shopping programs are rapidly losing their appeal to the reinsurers.

Well here we are, past memories of very conservative underwriting, lapsing into a wild orgy of nonsense called underwriting, now in a mid-phase confusion to all. Gould of Harvard has said, "In all biological systems as the systems mature the wide variances tend to fall out leaving the centrix position". Perhaps underwriting is following that biological pattern. Will sensible, intelligent, knowledgeable underwriting be the current mode?

How will the underwriting team meet this challenge? First and most important, everyone on that team is going to have to be an insurance person. I am now speaking directly to you! If you really want a future in underwriting you cannot be satisfied to continue to only provide a medical consultation service. You will have to learn the intracacies of the insurance business. And you must start with product mortality assumptions. You should have a say in what the mortality assumption will be. If you are to be held responsible for the underwriting results you better know what is expected. How many of the medical directors in this room know what mortality assumptions go into their Company products? How many are invited into the product pricing conferences of their Companies? How many know what asset share calculations are? These calculations demonstrate product profitability. By altering in a minor way the mortality assumption, you can easily see what happens to the expected profitability.

What expense factors are used in your products? How are they established? Your underwriting costs are an essential element in this assumption. Requirement costs are important. But please remember, each time you become more liberal in an amount/age requirement, you can expect the mortality results to shift also, and that shift is toward an increase in expected mortality.

However, this is not the entire story, simple if it was. Against these factors of mortality stability will come the unanswered question. What will happen to the product marketability if you insist on obtaining all the requirements you want and feel you need for a specified level of mortality? This question will test your overall insurance knowledge and judgement. Just remember if you are to be one of those held accountable for mortality results, if that responsibility is to be shared by you, you better get used to speaking up prior to the setting of the assumptions and the pricing of the product. You must make yourself a part of your Company!

There is an argument which has been going on ever since I started underwriting. Is underwriting an art or a science? Medical information is exploding, a complete changeover almost every five years. In that knowledge intensive environment, how can anyone sit back and say that little or no science need be associated with underwriting. And that scientific assessment requires a medical background.

How many of you have taken the Dick Singer/Bob Wood Mortality Seminar that ALIMDA has sponsored? This seminar gives you the knowledge and background to analyze current medical readings and transpose those clinical studies into meaningful mortality statistics.

Remember, however, it takes a very wise person to read well and analytically. Too many medical directors, lay underwriters and yes, even actuaries have committed the mortality sin. That sin is where population mortality is indiscriminately used for the expected mortality in analyzing medical results. When deriving mortality percentages for the purpose of arriving at ratings that determine premiums, select insurance mortality must be used for the baseline. Remember our select mortality is approximately 25% of population mortality in the first year, rises to approximately 50% by the fifth year and never goes over 75% through ultimate.

Hopefully you agree, underwriting is a science, but that is not enough. To be a good underwriter you certainly need to know more than just the medical aspects of underwriting. Underwriting is and always will be a blend of instinct, intellect, art and science. All these ingredients are necessary if the whole, you, are to be the Compleat Underwriter.

The Future of Underwriting? I believe it is bright. But for that future to be bright companies need to rebuild their underwriting team; need to redevelop their own underwriting style and philosophy. Expertise and pride must return to the selection process. Shopping programs should cease.

However, much depends upon you. For those of you who believe in the principles of underwriting, who want to be a part of the insurance business, who are willing to work at it, to know it, the future is bright - there is a light at the end of the tunnel of underwriting gloom. However, for those unwilling or unable to consider and develop underwriting into a true profession, I believe the Law of the Point of No Return will assert itself. That law states, "Always be aware when you enter a tunnel that the light you see may not be the end of the tunnel but rather the headlight of an onrushing train".

Deaths

John S. Pearson, M.D. late of
American United Line, Indianapolis, IN,
died on February 3, 1985.

John G. Walsh, M.D. of
Northwestern National, Minneapolis, MN,
died on February 9, 1985