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The purpose of this article is to highlight the great opportunity our clients have to lock in premium rates on level cost insurance.

In the CALU Info Exchange 2009, Vol 4, John McKay outlines his reasons for a Buyer's Market for level cost insurance products. His premise was that for various reasons, pricing of level cost products could not be sustained and that the life companies would have to significantly increase level cost pricing. Since that article, there are additional factors that indicate the "sale" on level cost products may soon be over.

Background

Both T100 and level cost products were initially introduced to the Canadian market between the mid-1980s and early 1990s. During this period of time there were two key product pricing factors which differentiate that environment from today's.

The first pricing factor is policy lapse rates. The policy lapse rates used by insurers in pricing permanent insurance products during this period were quite high as compared to what would be judged as appropriate and prudent today. Because these coverages do not provide any cash value, higher annual policy lapse rates used in pricing actually result in lower premium rates. This flows from the fact that part of the level premium paid on these policies is credited to a fund or reserve buildup within the insurance company. This reserve is used by the insurance company to help offset future mortality costs under the policy, which in turn permits the charging of a level premium. However unlike the regular cash values under a permanent policy, this reserve buildup is forfeited if the policy is cancelled. Such forfeitures benefit the insurers and, in fact, are assumed in the product pricing.

The second key factor is the level of interest rates generally. During the years that these products were initially introduced to the market, interest rates were above 10%. As a result, these products were initially priced anticipating the continuation of interest rates over the longer term at levels well above that which can be achieved today.

The bottom line is that both of these product types were introduced to the market at a time when the two most important pricing factors were at levels which tended to minimize the premiums established. Over the intervening years, actual lapse rates and interest rates have steadily reduced. Over the same period, there has been a significant improvement (i.e. reductions) in mortality rates which reflects improving life expectancies. However, the pricing benefit which improving mortality has provided to insurers is not nearly large enough to offset the negative impact of reducing lapse and interest rates.

The result should have been a material increase in T100 and LCOI rates since the mid-1990s. While there has been some increase in T100 rates through the 1990s as assumed

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lapse rates were reduced, there has been very little upward movement in level cost rates. In the latter part of the 1990s and during the first decade of this century, there has been a very significant reduction in long-term interest rates. This should have caused insurers to increase their premium rates further for these products. However, the reality is that insurance companies have been reluctant to increase product pricing for fear of losing market share in what are two very competitive product categories.

Rate of Return Analysis

One method of measuring whether there is a buyer's market is to calculate the pre-tax equivalent interest rate needed to accumulate the death benefit at life expectancy. Rates range from 8.2% to over 10% for individual policies and over 11% for joint second to die policies. These rates exceed actual interest rates by a significant margin.

Impact of Interest Rates

The rate of return on reserves is a significant part of overall pricing. Bond rates have steadily declined for over 10 years but level cost pricing has not been adjusted to reflect lower expected returns.

Table: Premium Increase Required to offset Impact of a Reduction in Interest Rates

Issue Age	1% Decrease	2% Decrease
30	+25%	+65%
40	+20%	+50%
50	+15%	+35%
60	+10%	+20%

Canada Revenue Agency

CRA is not happy with the amount of revenue it is getting from level cost products.

Essentially the revenues are sheltered from tax and the investment income tax does not provide sufficient revenue to cover the tax sheltered reserves. If tax legislation is changed to make sure that the internal accumulation of level cost policies is taxed, the insurers will be forced to increase level cost rates.

Summary

Manulife has already announced increasing rates for level cost policies. Can other insurers be far behind? Prices are still very attractive for level cost policies but anyone interested should act now while level cost is on "sale".

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