PACIFIC LIFE RE

GUARANTEED OVER THE HILL?

Re:think

EUROPE OCTOBER 2015

The 'Over-50s' market

Traditionally Over-50s products have been targeted to meet the basic funeral cost needs of lower socio-economic groups. The simplicity of product design and ease of purchase coupled with substantial marketing relative to other protection products have helped build commercial success. An aging population and high funeral cost inflation should ensure the demand side of the equation remains healthy. So is the future bright?

The market has had its share of regulatory and media scrutiny with the value, appropriateness and inflexibility of the product in particular coming under attack. Love or hate the product – there are certainly some further fundamental challenges emerging:

- A low interest environment looks likely to prevail and this puts upward pressure on premiums
- Comparison tools increasingly highlight lower cover compared with fully underwritten products
- Moratoria have been shortened under competitive pressures, whilst typical survival periods for severe diagnoses have lengthened well beyond their protective envelope
- More sophisticated customers are increasingly exploiting the limited selection criteria – intermediaries are also increasingly active in this market segment

If left unchecked these factors could lead to a downward "spiral" of customer value. In this publication we explore the drivers behind these changes and consider what steps the industry could take to ensure a flourishing market better able to meet the needs of its customers.

THE CURRENT MARKET LANDSCAPE

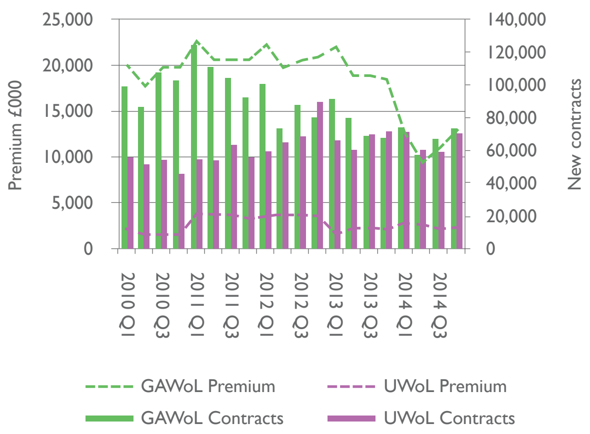
Sales

According to ABI statistics, sales of Guaranteed Acceptance Whole of Life (GAWoL) products have been in decline over recent years, with a sharp fall in the number of contracts sold in 2014 (to around 250,000). This was not mirrored by premiums, which only fell slightly, reflecting an average premium of around £16 per month in 2014 compared with around £10 in 2013.

By comparison, Underwritten Whole of Life (UWoL) business has recently grown slightly with both products now generating nearly £50m sales in 2014. The number of contracts sold remains much lower given the much higher average underwritten monthly premium of £73.

Clearly the two products are designed to meet the varying needs of very different customer segments. However, they are increasingly actively compared despite the industry's efforts to separately target the intended customers. The comparison is of course relevant and the defining difference, i.e. risk selection, plays a material part in recent Over-50s market developments.

ABI QUARTERLY NEW BUSINESS STATISTICS



Selection Criteria

The cornerstone of making Over-50s products easy to buy has long been "guaranteed acceptance". This replaced the historically cumbersome and intrusive underwriting process with a combination of other controls, most notably; an initial claim moratorium period and capped levels of cover (designed to deter or limit the impact of those in poor health). These controls combined with lower expenses partly offsetting higher residual risk costs helped make the product viable.

Over recent years there has been a shift from offering two year to one year moratoria. This shortening runs counter to substantial improvements in prognosis for even the terminally ill in the same period and has radically reduced the effectiveness of the moratorium. Given that typically a full return of premium or a potentially enhanced accident benefit are paid on death during the moratorium period, there is little down side for a customer in very poor health buying cover.

Going against this trend, Cigna have recently introduced a "semi-underwritten" product with four health questions allowing them to offer increased cover ("up to 30% more") to those eligible. This takes the product back towards its original Industrial Branch roots where a short form approach was typically used.

> "Cigna have recently introduced a "semi-underwritten" product with four health questions..."

Interest Rates & Inflation

Funeral cost increases have outstripped inflation over recent years and genuinely represent a challenge to those in the poorer socio-economic classes, despite the potential to claim state Bereavement and means tested Funeral Payment benefits. As already mentioned, this should drive increased demand for Over-50s products and has already helped to encourage growth in pre-funded funeral plans. The risk that inflation can reduce the purchasing power of eventual death benefits has given rise to escalating product options.

However, an explicit funeral expense inflation link is not viable and the additional complexity of such options, given the typical limited premium term, impedes the simple purchase. The strong behavioural tendency for customers to maximise their headline cover by selecting level benefits probably suggests "top-up" purchases are a more effective solution, although low awareness of funeral cost inflation remains an issue.

Interest rates fell steadily during 2014 and then underwent a more pronounced drop in Q4 2014. If reflected fully within premium rates, the drop since 2013 would have reduced the level of affordable cover for the typical monthly premium selected by around 4%. However, market rates appear to have been less sensitive generally to interest rates which have subsequently increased a little.

Distribution

The distribution landscape has evolved with increasingly high adoption of online buying and a growth in comparison based portals. Interestingly, for an essentially non-advised product, nearly 5% of the Q4 2014 policies sold were under the "Independent Advice" channel (typically this has been less than 1% in the past). Both of these developments have arguably led to customers making a more informed purchase.

> "Royal London's "protected pay-out" feature... fairer on those who cannot afford ongoing payments."

Treating Customers Fairly

There have also been a number of encouraging developments aimed at countering some of the most common criticisms of the product:

- You can pay more premium than the sum assured – in part this is just insurance pooling and should arguably be tolerated in the interests of affordable cover, but LV=s "capped premium" variant was a notable development going beyond the more typical premium cease age of 90.
- You lose everything if you stop paying premiums – again this makes cover more affordable for those able to continue paying premiums, but Royal London's "protected pay-out" feature reduces this cross subsidy and is arguably fairer on those who cannot afford ongoing payments.
- The benefit doesn't cover the cost of a funeral – as mentioned most providers now offer an increasing variant or allow further cover to be purchased in the future (up to a point). More could perhaps be done to highlight state benefits at claim stage.

Whilst there are some variations in the multiple of sum assured paid on accidental death and return of premium in moratorium, products are relatively consistent across providers, perhaps with the exception of ASDA's "Term Capped" version. We therefore believe that customers choose products largely on the marketing and brand as well as a judgement on the relative value of price compared to sum assured.

Claims Experience

We have already mentioned the market transition towards reduced moratoria. This occurred after the period covered by the most recent CMI industry study (actually 2003-2006 given difficulties in securing data for 2007-2010) so any adverse impact is not captured within published experience. However, even old published studies do show strong prior evidence of anti-selective take-up, with mortality rates much heavier than population experience except for the oldest ages (85+ i.e. those ages well beyond entry age limits). Whilst, in part, this reflects the lower socio-economic profile of customers the dominant feature is the impact of the lack of underwriting.

Our own more up to date experience analysis shows clear evidence of anti-selection. Over 50s experience is heaviest in the early years of policies across all ages (after allowing for the impact of the moratorium). Younger age claims experience is approximately seven times that expected from an underwritten product – even beyond the early durations where the strong positive initial impact of underwriting wears off. In some segments anti-selection reaches extreme levels, for example, for customers taking the largest premium option or purchasing multiple policies. Such segments can also have unusual socio-economic profiles given the targeted nature of the product.

> "…insurers who fail to respond to tightened risk selection initiatives may very quickly be exposed to further increased anti-selection."

CONCLUSION

In light of the emerging experience we believe it would be beneficial to tighten up on risk controls. Indeed, given the recent move by Cigna, we expect to see simple underwriting, eligibility criteria and other risk controls emerging into the market making the current product design increasingly non-viable over time. In our view, those insurers who fail to respond to tightened risk selection initiatives may very quickly be exposed to further increased anti-selection.

In particular, we have identified the following risk measures warranting consideration:

- Hold the moratorium to two years – at least in the absence of other controls
- Reduce the richness of non-accident related moratorium benefits, e.g. partial refund of premium potentially with some compensatory increase in accident cover
- Introduce some very basic underwriting criteria – in some cases smoking status is already asked and extending this to major health issues would work well for online applications
- Tighten controls around multiple covers and premium or benefit caps

Health questions could be applied as simple eligibility criteria (but at the expense of the "guaranteed acceptance" message). Alternatively, those disclosing impairments could be accepted but with potentially one or two year moratoria being applied. Potentially the moratorium could be limited only to "linked" causes of death. More simply, overall cover levels could be reduced via a rating.

These approaches are consistent with providing a better value product to customers by redressing the current heavy cross subsidy towards poor risks whilst retaining the core simplicity of the product. We believe that there is potential for both commercial success and improved customer value for early adopters.

ABOUT PACIFIC LIFE RE

Pacific Life Re works with clients in Europe, Asia, Australia and North America to manage their mortality, longevity and morbidity risk. We have built a strong, experienced team with a reputation for technical expertise, responsiveness, innovation and excellence in service delivery to our clients.

Pacific Life Re Limited is a wholly-owned subsidiary of Pacific LifeCorp, the parent company of Pacific Life Insurance Company.

For more information about Pacific Life Re please visit our website www.pacificlifere.com or follow us on LinkedIn.

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