Reviewable contracts
A contradiction with consumer implications?

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Firstly I would like to point out that I am here today to play a role – to role-play in other words. Some of the views expressed below may not be those of my employer, and more interestingly they may not even by my own views.

1. Insurability

When confronting insurance problems, I often find this a very good place to start. "What constitutes an insurable risk?" Elementary insurance text books tell us that the conditions that make a risk insurable are:

(a) the risk insured against must produce a definite loss not under the control of the insured,
(b) there must be a large number of homogenous exposures subject to the same risk,
(c) the loss must be calculable and the cost of insuring it must be economically feasible,
(d) the risk must be unlikely to affect all insureds simultaneously,
(e) the loss produced by a risk must be definite and have a potential to be financially serious – insurable interest.

Tabulating the several tests incorporated above we have:

	Pass test
Not under insured's control	Yes (probably)
Large number	Yes
Calculable	Yes (some may disagree)
Economically feasible	Yes
Catastrophe test	Yes (probably)
Definite Loss	Maybe
Financially serious	Maybe

Unfortunately the elementary text books do not explain why these principles of insurability are required, but concluding why should not be beyond our wit.

Depending on one's personal prejudice the above list can be interpreted as an acceptable pass or imperfect thus a failure.

Whatever one's disposition, it does seem rather unimaginative to respond to the short-comings by:

- refusing to provide guaranteed terms or
- proposing reviewability only.

A more considered response would be to pursue a process of tightening up the shortcomings so that the objections against insurability are reduced. Indeed a considered evaluation of the existing practices and "in the main" the trend of recent revisions[1] to guaranteed contract terms can be seen to be in the right direction.

2. Insurance vs Assurance

In my mind insurance relates to collective sharing of short term risk. Individuals seek to protect against a particular peril by agreeing to pay an insurance premium sufficient to cover claims expected over a short period of time (typically one year). Such is a rational choice (even in the long term) provided the risk incidence (and cost) is expected to reduce or remain reasonably constant over time.

[1] Time of writing – September 2003

On the other hand my definition of assurance relates to collective sharing of long term risk, typically subject to deterioration trend (increasing cost) over time and potentially effected by circumstances that may produce a significant step change to the level of the individual Insurance risk. It is a sad reality that being born produces this pattern of risk. But all is not lost provided others recognise their need for morbidity and mortality assurance, and thankfully many of us do.

Regrettably, this is not a sufficient analysis of the characteristics of assurance risks. At the start of an assurance contract all members of the collective see themselves as having comparably similar likelihood of claiming or not. However, with the passage of time the relative risk between members diverges. Some experience a very slow change in their relative risk, perhaps even improving, whilst others experience significant deterioration. Thus, arbitrage opportunities arise for the fitter to elect against their collective (and assurer) by opting out, potentially into another collective that recognises their preferential status.

Neve-the-less I do believe that most agree that a Guaranteed contract provides the best fit to the underlying characteristics of the risk to be insured (or is that assured). From my research there seem to be a number of clients and their advisors out there who agree with this. In the face of uncertain future – the consumer's requirement is for a guaranteed premium providing certainty. The reviewable premium simply misses the point.

3. Fair contract terms?

Whilst preparing for this presentation, I came across the following commentary on the internet:

> ***Policies that are only Guaranteed Renewable or Conditionally Renewable***
>
> ***Definition:*** *Guaranteed renewable promises the level of coverage the insurance carrier is providing you today will never be downgraded or taken away (for the life of the policy); however, this does not guarantee the price. Conditionally renewable simply means nothing is guaranteed.*
> ***Logic:*** *The best long-term disability insurance policies are both non-cancellable and guaranteed renewable. A contract that does not include both of these terms allows the insurance carrier complete control over both the coverage and the price of your insurance. As you age your risk of experiencing a disability increases. As a result, your business becomes less desirable to the insurance carrier. Policies that are only guaranteed renewable or conditionally renewable let the insurance company off the hook if it determines your segment of business is no longer profitable to it.*
> *Although guaranteed renewable ensures your level and quality of coverage will never change unexpectedly, it still gives the insurance carrier the option to raise the price to a level that may no longer be cost effective to you. In essence, they can price you out of your insurance.*
> *Contracts that are conditionally renewable give the insurance carrier more options for manipulating your contract. In addition to raising your premiums, the insurance company also can make adjustments to the quality of coverage in an effort to reduce payable claims. Many times, the latter option serves the carriers better because it does not stop your premium dollars from entering their bank account, but it reduces their risk of having to pay a claim.*

It struck me as odd that the commentary referred to Guaranteed renewable. Feeling myself to be reasonably educated about the intentions of a renewable policy design, I felt on second reading that the wording was unfairly critical. However, on third reading, the words feel uncomfortably justified if you change the words so that they contrast the guaranteed and reviewable products familiar to us.

Perhaps more alarming is that to all intents and purposes a reviewable contract is both reviewable for scope of coverage and reviewable for price. We've all seen this before –

Dear xxxx, we regret to inform you that the premium for your existing contract has increased by “Rude”%, but we are pleased to inform you that we have been able to negotiate much more reasonable terms for this alternative contract which is only slightly less comprehensive……

To date our reviewable contracts have typically been linked with investments. We all know the flexible whole of life contract which is predicated on highly optimistic investment assumptions to produce maximum cover for the policy holder. At review the premium reflects the investment returns actually achieved and the new projected assumptions. At least we could blame the factual performance of the investment markets.

Turning our attention more specifically to the design of the reviewable contract we should all concede the following:

- the intention is that the quoted level premium should be sufficient to meet the cost of claims if the assumed pricing assumptions turn out to be accurate.
- The premiums are level which means that policy value is built up in the early years to cover higher cost of claims in later years.
- Underlying pricing assumptions are not disclosed to policy applicants at commencement of the contract. From their uninformed stance they could quite reasonably assume that the cheapest contracts are best value.
- At review the magnitude of any change in rate will be related to the adequacy of the original pricing assumption – the more optimistic the original assumptions the greater may be the requested increase.
- At review the policy-holder does not have an open market option. There is no competition, the policyholder must either:
    - accept the terms offered or
    - surrender his policy and his policy value or
    - he could challenge the fairness of the contract terms.

I’m sure we can all reflect on this ourselves, but to stimulate the cogitation I’d like to just mention the following, which might have implications for Reviewable policies:

- The 1999 Unfair Contract Terms [Act] include the following clauses in relation to unfair terms:
    - (f) authorising the seller or supplier to dissolve the contract on a discretionary basis where the same facility is not granted to the consumer, or permitting the seller or supplier to retain the sums paid for services not yet supplied by him where it is the seller or supplier himself who dissolves the contract;
    - (i) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;
    - (l) providing for the price of goods to be determined at the time of delivery or allowing a seller of goods or supplier of services to increase their price without in both cases giving the consumer the corresponding right to cancel the contract if the final price is too high in relation to the price agreed when the contract was concluded.

  A more thorough study of the Law may lead some to conclude that the reviewable contracts aren’t caught by the above. But I’m no lawyer.

- Guaranteed contracts also build up policy value (implication behind point (f) above) , which is not returned on surrender of a policy. However, there is one important difference the guaranteed contract is a long term contract in which the vendor specifies all the terms and costs at the start. The decision to break the contract is not precipitated by an action of the vendor. Most specifically the vendor does not change the price.
- Perhaps fair review terms might include an alternative offer to return premiums paid in excess of the renewable alternative or to offer an open market transfer of reserves to a competing carrier who offers more acceptable terms for the policyholder.

I hope we've all got our pricing algorithms right then.

I refer the interested reader to the following web site for a more comprehensive commentary: **http://www.oft.gov.uk/Business/Legal+Powers/unfair+guidance.htm**

4. CI claims projection

Anyone who has a more than passing familiarity with this product will recognise that CI is essentially covering cancer, heart attack and stroke (plus death if you are considering the Accelerated product). The long list, whilst not something I would wish to advocate, does tend to receive more attention than it probably deserves. This shorter list of claim conditions does seem to make the product significantly more tractable.

Whilst I agree that it is important to look at the breakdown of even this shorter list of conditions (which we did to some degree at last year's conference), I feel it is still instructive to keep in mind the aggregate population trends. Population trends are probably on balance favourable for heart condition claims (which, due to lifestyle changes probably will help for strokes). Cancer trends are equivocal, but medical advances hold out much promise - perhaps some discomfort from early diagnosis in the short term, but longer term, prospects for pre-cancerous diagnosis are encouraging and elimination of certain cancers is feasible.

I have mentioned a number of favourable developments in the presentation, and but for shortage of time, we could discuss these matters for very much longer.

5. In Summary

1 – I've taken us back to our elementary text books and pointed out that the product looks more like it passes the criteria for insurability and that the right way to improve it is to address the criteria that seem a little flaky.

2 – I've pointed out that Guaranteed assurance is the right product for a deteriorating risk - reviewable is essentially a short term contract and a poor fit to the risk.

3 - Reviewable contract has some thorny legal problems - Unfair contract terms may well produce serious mispricing consequences for the future. I've suggested that the contract may be unfair if the insurer does not offer a refund of "deposit premiums"/"policy value" built up as a reserve for the future (less of course something for the option to continue in cover without further underwriting).

4 - CI is essentially covering cancer, heart attack and stroke. Background population trends are probably on balance favourable for heart attack (and may also help for strokes). Cancer trends are equivocal, but medical advances hold out much promise - perhaps some discomfort from early diagnosis in the short term.

Finally I leave you with a quote or two to ponder:

"Behold the turtle. He makes progress only when he sticks his head out" –
James B Conant

"The industry does not serve its long term viability and reputation well by responding in such a way that it no longer provides a desirable service that is of benefit to society as a whole." – *GB Lane*