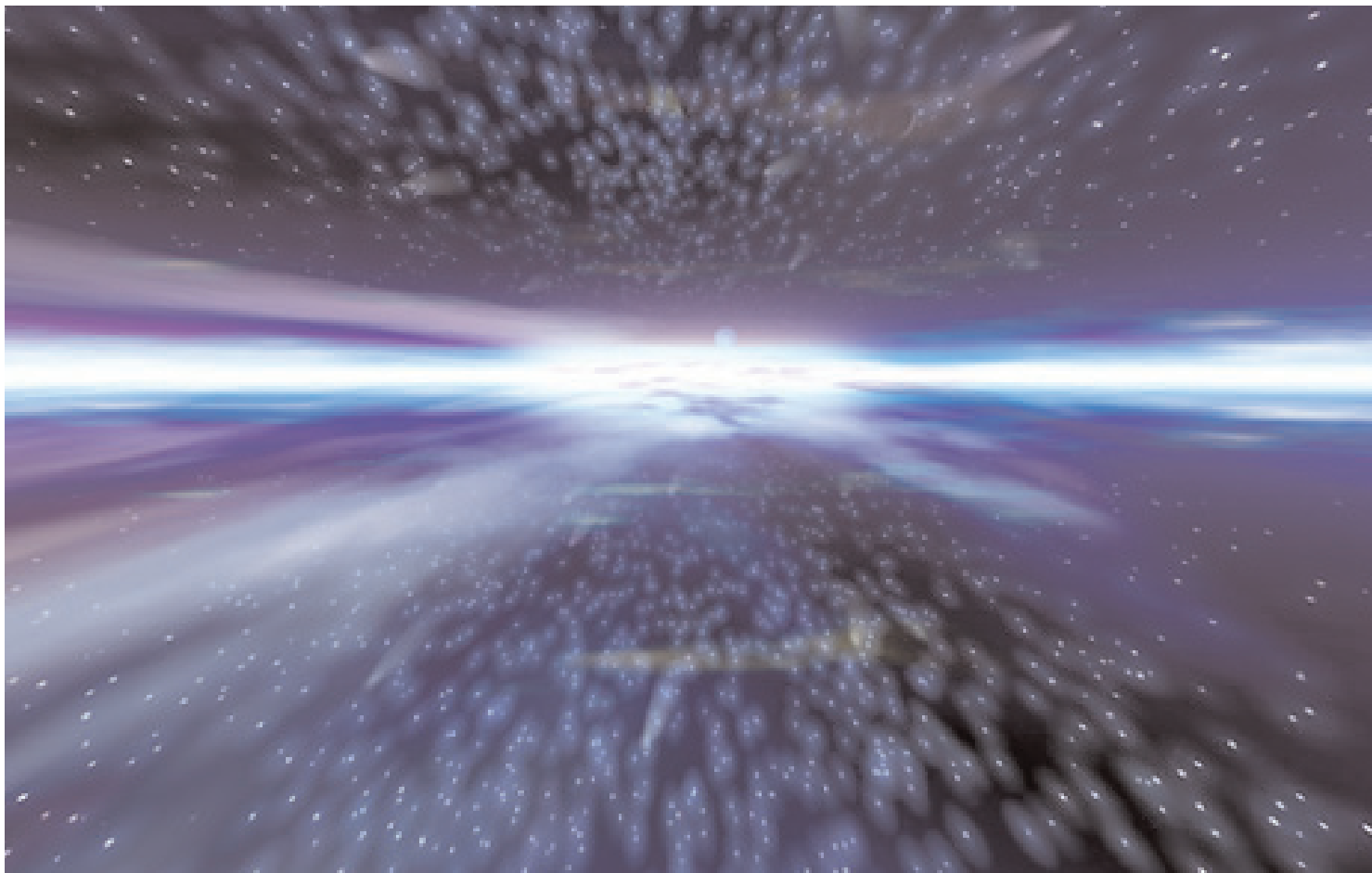


Critical illness



The beginning of a new year always seems like a good time for crystal ball gazing. This one is no exception. In the following article we take a fresh look at the critical illness market and venture a few cautious predictions.

Critical illness has undoubtedly been the most successful new protection product of the last twenty years. Sales have grown strongly ever since it first appeared in the mid 1980s, and critical illness is now the UK's best selling protection product.

In terms of coverage, around 11 million adults and children are now protected – with a total sum assured in excess of £400 billion. In addition, despite its relative infancy,

it is estimated that over £500 million has already been paid out in claims.

Despite this unparalleled success, all is not rosy in the critical illness garden. The last two years have seen growing concerns over the sustainability of the product in its current form – particularly over the question of guarantees. Talk abounds of so-called next generation products.

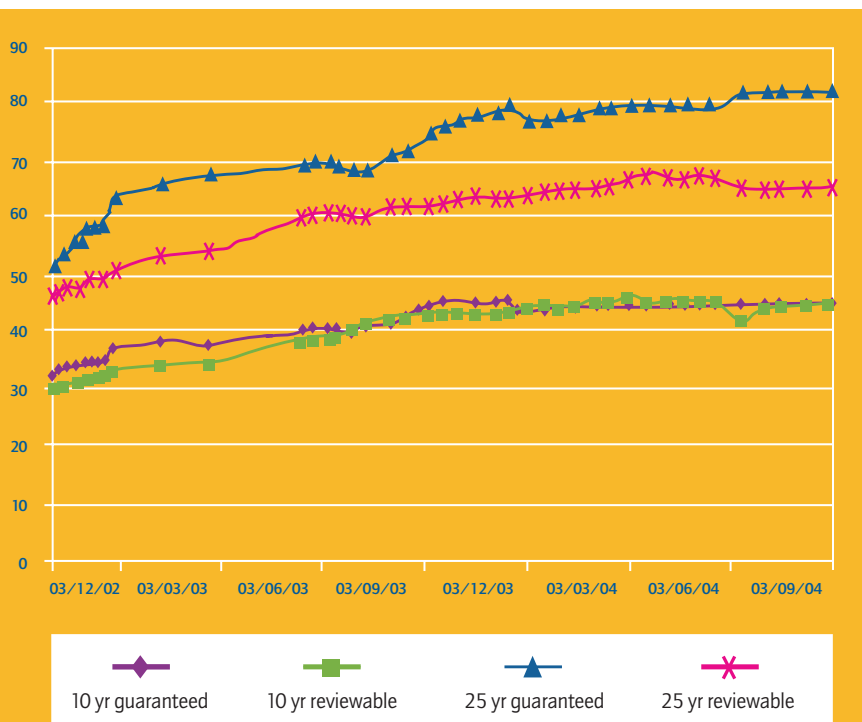
Providers are increasingly concerned about the potential for an increase in claims resulting from medical advances, and, in particular, from screening techniques used to diagnose cancer. We previously reviewed the key developments and their impact in the article No Guarantees with Screening Programmes in the October 2004 edition of In Focus.

The world of medicine never stands still for long, however, and since that article appeared further announcements have been made on the development of potential screening tools for bowel cancer and new approaches to the treatment of prostate cancer.

In the light of such developments, insurers' understandable fear of the unknown has led to significant premium increases for guaranteed critical illness products and to several providers withdrawing from the market altogether.

Graph 1 shows the increase over the last two years in average market premiums for a sum assured of £100,000 based on sample ages, terms and contract types.

Graph 1 Increase in premiums for a sum assured of £100,000



Average premiums for guaranteed critical illness products have increased by over 40 per cent for 10-year terms, and by almost 60 per cent for 25-year terms. The comparable increase for reviewable premiums has been around 40 per cent for both terms.

For 25-year terms the average differential between reviewable and guaranteed covers is now over 25 per cent, whereas for 10-year terms there is little difference between the two. As we all know, averages can mask the existence of different trends at different points of the spectrum. So this is something worth examining in greater detail.

Sales of protection products in the UK remain heavily linked to mortgage provision, and critical illness is no exception. The table below shows the change in premiums over the last eighteen months for a £100,000 sum assured for a 25 year term based on the average of the best quotes from The Exchange for males and females aged 30 and 45 next birthday.

Changes in premiums for a £100,000 sum assured for a 25 year term

(Source: The Exchange)

	July 2003	November 2004	Increase
Age 30 next			
Male non-smoker	£30.00	£32.50	8.3%
Male smoker	£51.60	£57.30	11.0%
Female non-smoker	£31.70	£32.60	2.8%
Female smoker	£49.60	£54.30	9.5%
Age 50 next			
Male non-smoker	£109.50	£133.90	22.3%
Male smoker	£199.60	£251.20	25.9%
Female non-smoker	£93.80	£108.40	15.6%
Female smoker	£167.30	£183.80	9.9%

Not surprisingly, the comparison shows that the percentage increases are generally larger for older ages and for smokers. The figures also highlight the fact that guaranteed critical illness cover is no longer necessarily a cheap option. Comparative premiums for life-only cover would be in the range £20 to £50 at age 45 next, and only £8 to £12 for age 30 next.

In a mortgage context, therefore, the additional cost of guaranteed critical illness cover represents a significant extra at a time when most people have more immediate financial concerns.

Increasing premiums have no doubt contributed to falling sales of critical illness over the past year. Half-year figures from the ABI showed total new critical illness premiums down 15 per cent on the same period in 2003. If we factor in increasing premium rates, the actual number of policies sold shows a much more pronounced decline.

There will be those who point out that dramatic premium increases have led a number of insurers and reinsurers to re-enter the guaranteed critical illness market – potentially returning some stability to the market. But even the more optimistic would accept that this is a temporary extension to the lifetime of current guaranteed critical illness products rather than a permanent reprieve.

Medical advances, particularly in the diagnosis and treatment of cancer, will inevitably continue. Karol Sikora, a leading cancer specialist, recently predicted that within ten years cancer will have become a chronic, controllable disease. If this turns out to be even partly correct, we should perhaps question whether cancer still fulfils the necessary criteria for inclusion in a critical illness product.

So what are the options for the future of critical illness in the UK? At present the only obvious alternative is that of reviewable premiums. As mentioned above, there is already a significant differential between premiums for reviewable and guaranteed cover. From a purely financial perspective there must be an argument for choosing the reviewable route. To date, however, we have not seen a significant switch away from guaranteed critical illness, and with this option likely to remain available for the foreseeable future at least, it seems unlikely much headway will be made.

We should also bear in mind that the whole issue of reviewability is currently clouded by the recent FOS statement and the ensuing industry discussions. At this stage it is impossible to say when and how these discussions will be resolved. An Institute of Actuaries working party is also examining the concept of reviews from an actuarial perspective, and this may lead to professional guidance at some point in the future. Against this background of uncertainty, it is hardly surprising that many providers remain less than fully confident that reviewable rates are the way forward.

Conceptually there is some logic to reviewable contracts – and by extension renewable contracts – where neither the premium nor the definitions are guaranteed. From the consumer's point of view, they provide affordable initial cover with the option to reassess protection needs in the future as income rises. There are also clear advantages for the provider, in that premiums and cover can, if necessary, be amended as circumstances change. We should perhaps question, however, whether it is right to pass on risks to the client that we cannot quantify as providers.

Advocates of reviewable contracts point to other forms of insurance, motor in particular, where consumers appear willing to accept the absence of long-term

guarantees. But there are a number of key factors at work here which do not apply to critical illness.

Firstly and most obviously, motor insurance is compulsory and therefore bound to be accepted – perhaps grudgingly – by consumers. Secondly, increasing motor premiums over time have a natural offset in the form of credit given for age and past experience. Annual increases are therefore generally modest, except where a claim or driving offence has occurred. With critical illness, on the other hand, there is a natural tendency for rates to increase with age. Finally, of course, with motor insurance the fundamental cover does not change, and any changes tend to be limited to peripheral items such as excesses, windscreen cover and so on.

All of these distinctions raise serious doubts as to whether reviewable or renewable cover is the way forward for critical illness. It is also worth reflecting that public trust in the life insurance industry is not exactly at an all time high. Whilst this may be due to issues unrelated to protection cover, simply asking consumers to “trust us” on potential future premium increases or cover changes is unlikely to inspire overwhelming confidence.

So, for the immediate future at least, the industry's options are likely to remain limited to some form of guaranteed cover. The challenge therefore is to develop alternative product structures that provide sustainability going forward.

Given that providers' primary concern is the potential impact of medical advances, it is no surprise that a lot of attention has been focused on developing alternative definitions for the key illnesses – cancer in particular.

In this context, the ABI's Critical Illness Working Party recently announced that identifying ways of developing future-proofed definitions would be a key element in its 2005 review of the product. The object would be to reduce future incidence by incorporating some form of severity measure into the definition that would limit claims to cases where there was a genuine need.

Whilst this would undoubtedly reduce future uncertainty and make premium setting less challenging, we should perhaps sound a note of caution before heralding it as the saviour of critical illness.

Introducing a sustainable definition would probably require the inclusion of further medical terminology, on cancer staging for example. The question must then be how comprehensible this would be to consumers. As we strive to develop future critical illness products, the last thing we can afford is a loss of confidence stemming from concerns over individuals having ‘the wrong kind of cancer’.

Another option in a similar vein may be to introduce tiered benefit structures, whereby a full payout is made only in the most severe cases – with less severe events resulting in reduced payouts. There has been some limited development along these lines already, particularly in the area of prostate cancer.

There have been a number of developments in this area recently in South Africa, the original home of critical illness as we know it. The latest products there encompass benefit tiering with payout levels varying from 25 per cent to the full 100 per cent. Variants also exist which provide additional payouts at the 5 per cent to 15 per cent level for more minor events.

Whilst this type of structure also requires some measure of severity – and potentially additional medical terminology – in the definition, it does have the advantage of providing some form of payout in a wider range of cases. The situation in South Africa, however, is more complex in that there is a

yet no standardisation of definitions or illnesses covered. This makes it difficult to compare products and has led to calls for the introduction of standardisation along UK lines.

Finally, we should not ignore those who advocate that critical illness as we know it has had its day and that we should concentrate on developing other products more appropriate to customer needs. The obvious starting point is income protection which provides a solution to an alternative consumer need which many argue should be addressed before critical illness.

Whilst the argument has obvious merit, the difficulty with income protection is that – despite its obvious benefits – it has never sold well and has been the subject of perennial discussions as to why this is and how things can be changed. A full discussion of the whys and wherefores is beyond the scope of this article, but it is difficult to envisage income protection losing its Cinderella tag overnight.

A more promising route, therefore, might be to combine the benefits of income protection with critical illness in a so-called hybrid product. We can envisage many potential designs. One such might enable a more modest lump sum to be paid on diagnosis to cover immediate one-off expenditure, together with an income for a limited period whilst the individual remains incapacitated. In more serious cases the income would continue, much as income protection does now. A further lump sum could also be made to cover additional one-off expenditure.

Whilst anticipating future developments is never easy, it seems safe to say that critical illness is unlikely to continue indefinitely in its current form. Widespread concern over the sustainability of the current product has led to reduced choice and increased premiums. This is clearly not in the interests of the consumers this industry is here to serve.

A number of possibilities have begun to emerge, and the hope must be that these will lead on to a new era of product development and innovation. In taking these possibilities forward, we must never forget that different individuals have different needs. There is no one solution that will work for everyone.

Some will prefer the certainty of guarantees; others a cheaper price. Some will want a lump sum; others income. Rather than seeking a single solution to the current situation, we need to develop a range of different products to ensure as many customers as possible can find the right protection at the right price.

Obviously the use of the term critical illness entails certain restrictions; but this should not hold back sensible product development. Whatever the future may hold, you can rest assured that we at Hannover Life Re will be here to help with your needs.

Stuart Hill
General Manager – Marketing



Longevity

The subject of Longevity has become a much discussed topic lately. The fact that people in the UK are living longer is one of the key drivers of the 'pensions crisis' we keep hearing so much about. This has transformed longevity from an obscure subject, discussed almost exclusively by actuaries and academics, to the stuff of tabloid newspaper reports.

The current low interest rate environment now means that the mortality assumption is a much more important element of our annuity rates than has been the case for a very long time and the resulting mortality experience will be a key item of profit or loss for annuity carriers in the future.

At Hannover Life Re (UK) we are often asked to reinsure mortality risks on large blocks of in force annuities. This article explains why we may currently find this less attractive than you might expect or perhaps hope for, why we are much happier reinsuring blocks of life assurance business, and why - as a worldwide reassurance group - we are particularly interested in the enhanced or impaired annuity market.

A paper entitled **Longevity in the 21st Century** presented at an Institute of Actuaries' sessional meeting during 2004 noted divergent perceptions on the part of reinsurers and life offices respectively as to the appropriate price for reassuring longevity risk from annuities. The paper comments that the experience reinsurers have had of monitoring both the improving mortality experience in protection business, and the potential for medical advances, which will impact critical illness business, has perhaps given reinsurers early warning of the potential effects of medical advances in the annuity market.



Reinsurers may have learned this lesson early, but our life office counterparts have caught up quickly! Historically, however, there has been an important distinction between protection and annuity business. Over the years we have applied totally different methods of risk selection for each.

With protection business, we have become very efficient in linking selection of the risk to the risk factors and pricing. Although we have not gone as far as the US in terms of the range of factors considered, we still employ age, sex and smoking status - combined with a range of medical and lifestyle selection tools, ranging from a simple proposal form through doctors' reports, medical examinations, blood tests and so on. Introducing genetic testing raises a raft of issues of its own, but we do feel we can get a good feel for the risks we accept.

With the historic annuity market, by contrast, the only available selection factors have been age and sex (or just age in the case of protected rights business). Our annuitant pool comprises an extremely wide range of lives with totally differing mortality experiences. Inevitably, our pricing has been nowhere near as sophisticated as with protection business, likewise our mortality investigations.

To take a simple example, consider the reasonably well-known effect of purchase price on annuitant mortality experience. The increase in the commutation limit to £15,000 proposed under the 2006 pensions legislation could remove many lives experiencing worse than average mortality from the annuitant pool, lightening the remaining pool's future mortality experience still further.

This thinking has informed our growing interest in impaired and enhanced annuity products. We have tried to analyse the risk we are running and aim to link our pricing and selection to gain a better understanding of these risks. To draw the link between protection and annuity business again, in the case of protection business, it would seem at first sight that insurers might find healthy lives more acceptable than unhealthy. But over the years insurers and reinsurers have become very comfortable accepting the vast majority of unhealthy lives at increased rates.

As the annuity market moves to include a greater proportion of impaired and enhanced products, we clearly now find these lives more attractive. Selected out of the main pool, they have a shorter life expectancy and therefore less time in which to benefit from mortality improvements affecting the general population. But just as we have become comfortable with unhealthy lives for protection business - so long as they are properly selected - we may also become more comfortable with the healthy lives for annuitant business as the enhanced market grows. I would add one (possibly major) caveat here: we must first understand projected mortality improvements considerably better.

This is all fine in theory, of course, but there could yet be a major practical hurdle to overcome. As selection grows, the effect described above on what we might now call the standard market becomes inevitable. This will mean that wealthy and healthy lives with larger pension funds (including, dare I suggest, some readers of this article!) will receive the lowest annuity rates. Many of these lives (not necessarily those readers!) could well become dissatisfied with this situation. This would compound the current situation in which our clients already believe annuities provide poor value, despite the fact that we in the industry are worried about profitability.

If (or when) the annuity market does effectively move to an underwritten market, it is difficult to see how this change could be reversed. The transition could turn out to be fairly traumatic for companies who are slower to adapt - as those of us old enough to remember the move to smoker/non-smoker rates for life assurance will testify. But, in the long run, would we not - as insurers and reinsurers - be better off having found a way of improving our risk selection and hence our understanding of what has become a very difficult product to price?

David Brand
Managing Director

We hope you enjoy **In Focus** and we welcome your feedback, please forward any comments to Kirsteen Grant. If you wish to be added to our mailing list contact Kirsteen on 01344 846833 or email uk.marketing@hannover-re.com.

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