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Request to Change UL Death Benefit Option—Is It Appropriate to Underwrite?

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Most universal life forms offer two death benefit options: a level-benefit option, usually called Option A, and a level-benefit-plus-cash-value option, usually called Option B. The pricing actuary usually assumes that the net amount at risk under Option A tends to decline, *a la* whole life; the net amount at risk under Option B is level (unless the contract goes into corridor, at which point the death benefits are the same under both Option A and Option B). But if the owner pays minimum premiums, i.e., just enough to cover the monthly deductions, the net amount at risk is (roughly) level under Option A as well—a risk the insurer contractually assumes at issue. In contrast, if extra premiums (and/or high interest/low COIs) push the contract into 7702 corridor, the corridor makes Option A benefits like those for Option B, and the risk rises—a risk which was assumed in the contract as issued.

Despite the risk pattern assumed in pricing, virtually all insurers underwrite both death benefit options the same at issue. In other words, the same underwriting requirements are imposed for $1 million coverage for Option B as for Option A. This makes sense, as the net amount at risk is roughly equal at issue, the contractual risk assumed is the same, and the benefits (to the insurer) of underwriting diminish with time, especially after the two-year contestable period has passed.

Most of these contracts allow the owner to switch options after issue. However, if the switch is from Option A to Option B, the face amount is usually reduced by the current cash value, thus keeping the death benefit from changing at that point. This effectively prevents the owner from antiselecting for a sudden increase in death benefit by switching death benefit options.

Some have wondered whether there is still a potential loss due to antiselection despite the reduction in face. Suppose an insured becomes terminally ill while the policy is on Option A. If the insured switches to Option B, the face amount is decreased by the cash value, and the death benefit does not change at that point. But the net amount at risk is fixed for life (except for corridor, which produces the same benefit under Option A) at a level which is lower than that originally underwritten.

If the insured then stops paying premiums, the net amount at risk is still fixed at that lower level. The cash values will rise or fall depending on whether their growth exceeds the monthly cost (and whether any waiver for disability is in effect), roughly similar to Option A. If the insured begins dumping in extra premiums (e.g., for the tax advantages), the net risk is still fixed at a low level, and the insurer is likely to gain from the spread on the invested assets. So even though the death benefit would go up, it does not pose an extra risk to the insurer.

Suppose, on the other hand, the terminal insured stays with Option A. If no more premiums are paid, the net amount at risk could rise, especially if any withdrawal privileges are exercised. However, this was the risk that the insurer assumed at issue. So the risk to the insurer is actually greater for those that do not switch death benefit options.

Occasionally, a form reserves to the insurer the right to require evidence of insurability for a death benefit option change despite the simultaneous decrease in face amount which keeps the net amount at risk constant. In light of the discussion above, this seems inappropriate, and even counter-productive. It may also be illegal, as it would involve re-underwriting risks that were already assumed.

There seem several potential problems with underwriting at the point of the switch. First, this could compromise the evidence that is contestable in the first two years. If an insured switched in the second year, it could be very awkward for an insurer to contest a claim based on information that was not obtained at issue. After the second year, it is not clear whether or not the insurer has the right to contest, regardless of the new information received through underwriting an option change.

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Insurers are not compelled to offer policy owners the right to switch options, so it seems awkward to require evidence when the insurer has allowed it in the contract and reduced the face to avoid antiselection. Furthermore, the potential for an increasing or level net amount at risk is assumed by the insurer in the contract issued as well as when a minimal premium is paid. To require evidence on the same (or lower) amount at risk is unfair and could deceptively affect the risk purported to be assumed by the insurer, thereby violating many states' laws.

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