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GROUP CONVERSION CHARGES—ACCOUNTING FOR ANNUAL STATEMENT

DICKINSON C. DUFFIELD

THE accounting for Group Conversion charges in the annual statement, which at one time was quite simple, has recently been complicated by Group reinsurance in general and by the huge Federal Employees Group Life Insurance case in particular. In the belief that a description of these complications, and the manner in which they have been resolved by one company, may be of interest, this note is submitted.

The assumptions used in computing these charges are beyond the scope of this note. It will be understood that the charge is usually expressed as a flat amount per $1,000 which is computed, on an assumed average distribution of converted business, as being the amount necessary, in addition to the normal standard premiums paid by the insured, to carry out the terms of the converted contract, taking account of the higher mortality to which Group Conversions are subject as well as a somewhat different expense pattern (*e.g.*, reduced or no commissions are usually paid) from that of other Ordinary policies. As far as I can determine, this subject was first mentioned in actuarial literature by Cammack in *TASA* XXXIII, 347, wherein he suggests an extra charge of $50 per $1,000. The same author in a later paper, *TASA* XLI, 439, arrives at an average charge of $67.38 per $1,000. The costs in general are discussed in *TSA* 1951 Reports, pages 90 ff., and an average charge of $69 is mentioned. In the author's company the current charge is $65. It should be noted, however, that this charge can vary considerably depending on the assumptions used, the form and age distribution of conversions, and the scale of premiums charged on Ordinary policies.

Before the emergence of large reinsured Group cases it was our practice merely to apply the per $1,000 charge to the amount of Group Conversions issued and charge the resulting amount against the operations of the Group Insurance Line, crediting the same amount to the Ordinary Line. We did not consider it necessary to make any book entries since the company as a whole was not affected. This is apparently all that is contemplated by the present form of statement, since line 12A on page 5 of the 1955 Association Blank has x's in the total column. The Group Department will, of course, take account of such conversions in the experience rating of individual Group policies. The Ordinary Line carries an "excess mortality reserve" on the Group Conversions in force, which amounts to the difference between a gross premium reserve, on the group conversion assumptions, and the legal reserve. Here again we are not now particularly concerned with such assumptions.

When we come to the reinsured Group Life case the nice balance discussed above and contemplated by the Association Blank is upset. In a reinsured case the assuming company will usually share with the direct company all premiums, expenses and claims, *including* conversion charges. However, the Ordinary policy issued in conversion of the Group coverage will not ordinarily be shared. Let us assume that John Doe, an employee of the XYZ Manufacturing Company, is insured for $10,000 in its Group Insurance plan, of which the direct insurer is Company A which, however, cedes the business 50% to Company B. The Ordinary Department of Company A charges its Group Department $65 per $1,000 for conversions. If Doe terminates his employment with the XYZ Company and converts his insurance, the full $10,000 Ordinary Insurance will be written by Company A. He perhaps has never even heard of Company B. When the conversion is effected, A's Group Department will have to pay $650 to its Ordinary Department, but it will later be reimbursed by $325 by Company B's Group Department. It is thus evident that, after this transaction, neither company's charges to its Group Line will be in balance with its credits to its Ordinary Line. Before this situation became of much moment it was our practice to account for these intercompany conversion charges as expenses. However, with the advent of the Federal Employees case this no longer seems satisfactory. We have taken care of this in our company by opening a special Group reinsurance conversion account to cover the situation. The amount in this account, which usually has a debit balance in our case, represents charges to the Group Department which are not offset by any corresponding credits to our Ordinary Department and vice versa. In the annual statement we have removed the x's from line 12A on page 5 and have included the excess conversion charges in that line. (We have also, of course, entered a corresponding special line on page 4.) Conversion charges put through the books are shown in a special line 18A on page 13, while the outstanding conversion charges are shown as item 11.2 on page 3.

Those companies which participate in the Conversion Pool of the Federal Employees Group Life Insurance are confronted with a further problem which it may be of some interest to describe. The Federal Employees Group Life Insurance is insured pro rata by a large number of companies, each company bearing an assigned share of premiums, expenses, claims *and conversion charges*. The administering insurer charges these conversion items against the Government at the rate of $65 per $1,000, and turns them over to the Conversion Pool. The employee who terminates his employment with the Federal Government has the unusual option of being allowed to choose the company with which he wishes to convert his Group insurance. Companies which agree to write the conversions participate in the Pool. It is thus apparent that there will be no relation between a given company's share of the Group *insurance* and its share of the Group *Conversion Pool*.

Before proceeding further, it may be desirable to give a brief description of the manner in which the Group Conversion Pool operates. The Group Conversion Pool was set up in order to spread the risk uniformly among all companies writing such conversions. The company issuing the Group Conversion policy has exactly the same relations with the policyholder as it would with any other Ordinary policyholder. However, it makes annual deposits into the Pool on a prescribed scale, together with extra deposits in the first year of insurance which approximate the expense savings due to the absence of commissions on these Group Conversions. While these amounts are physically paid to the Pool Managers they are earmarked as being to the account of the issuing insurer and are immediately capitalized on its books as a ledger asset "Share of F.E.G.L.I. Pool Fund." Contrariwise, amounts equal to any death claims are refunded by the Pool Agent and credited to the same ledger asset account. So far, it will appear that none of the transactions between the company and the Pool have any effect on the surplus of the participating company. However, the Pool Managers will, from time to time, inform each participating company of its currently estimated share in the total Pool, which share is obtained by an averaging process which need not concern us here. Any difference—usually positive—between the amount reported by the Pool Managers and the amount resulting from the company's own deposits and withdrawals from the Fund will affect surplus. The problem then arises as to how such excess should be handled in the accounts and in the annual statement. In our company we have decided to treat such excess amounts as credits to the Ordinary Department on account of Group Conversions. It is apparent that these are not offset by any debits to our Group Department. Our reasoning in adopting this treatment might be set forth as follows: the Conversion Pool in total consists of the accumulation at interest of the deposits less withdrawals of the participating companies plus the $65 conversion charges less Pool expenses. Therefore, any excess amount recovered by one of the participating companies could be regarded as its share of the conversion charges credited to the entire Pool. Such amounts have been carried as a deduction from line 12A and credited to the Ordinary Insurance Line, with no offsetting charge to the Group Insurance Line. Furthermore, since the notice of the excess amount to which the company is entitled was received after our 1955 books had been closed, it was necessary to treat such amount as a non-ledger asset for the annual statement, with the intention of entering it on our books in the succeeding calendar year. The usual excess mortality reserve is maintained for F.E.G.L.I. Conversions.

In view of the above, it now appears that in order to obtain the Group Conversion charges it is no longer sufficient to make an equal transfer of funds from the Group to the Ordinary Department, but it is necessary also to take into account the following items:

1. The net amount of Group Conversion charges on the company's books split between credits to the Ordinary Line arising from the Conversion Pool and debits or credits to the Group Line arising from reinsurance transactions.
2. The estimated amount of outstanding conversion charges on cases on which the company is assuming reinsurance, less similar amounts on cases on which the company is ceding reinsurance.
3. Any amounts of the company's share of the F.E.G.L.I. Conversion Fund in excess of those resulting from the company's own operations which have not yet cleared the company's books.

The above describes the method in which this variety of problems has been handled by one company. It is hoped that this note will precipitate discussion of these problems, possibly resulting in alternative solutions.