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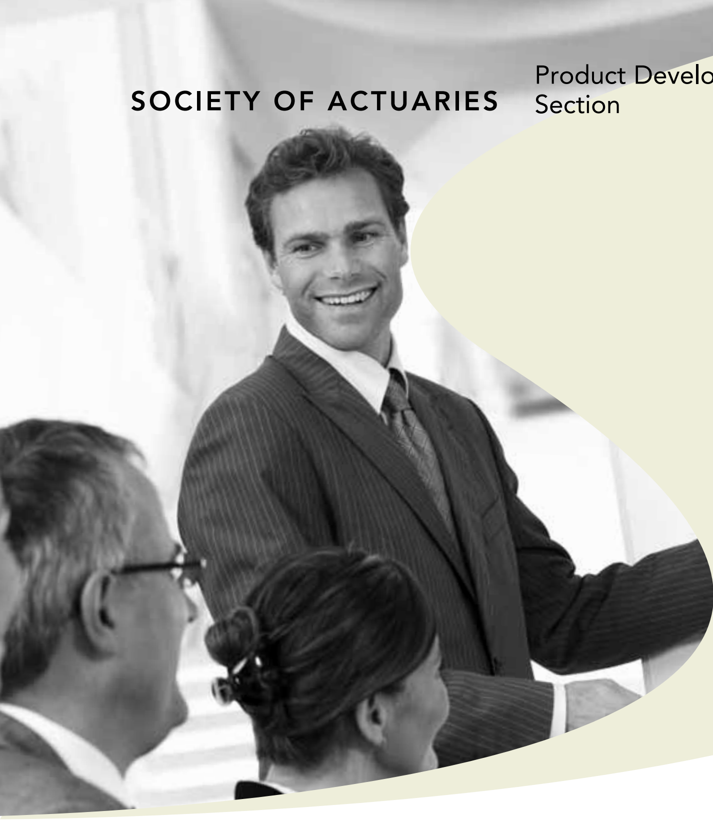

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Term Conversions – A Reinsurer's Perspective

By Tony Zajac

The right to convert a term life policy to a permanent plan has been a key component of term products for many years. This valuable option allows term policyholders, with certain restrictions, to switch to a permanent plan without new underwriting. At the point of sale, the conversion privilege can alleviate concerns about either losing coverage at the maturity of the term product or having to pay rapidly escalating premiums to keep coverage in place after any level-premium period. As with any valuable option, term conversions have a material cost; one that could easily be underestimated if not carefully evaluated.

Direct Writer Term Conversion Considerations

Because conversions are an option, policyholders will decide whether or not to exercise them based on their situation during the conversion period. Mortality anti-selection will occur for those choosing to convert to a permanent plan, since conversions include insured individuals who need to continue coverage and cannot qualify for a new policy at standard rates.

Estimating the impact of conversion mortality anti-selection has been difficult.

- Administrative systems have not always been programmed to contemplate tracking term conversions. Systems may not have identified converted policies separate from original issue permanent policies. Even if they did, they may not have tracked from which term policy or plan it was converted.
- Level term products often allow conversions up to the end of the level period. In most cases, it would make sense for the insured to wait as late as possible to convert to a permanent product, since the term premiums will generally be less expensive than perma-

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nent plan premiums for the same attained age. This means historical experience may understate the potential total number of conversions from more recently issued term plans, where policies are still far from the end of the level period.

Sparse experience data, when combined with vigorous price competition, gives just the right set of conditions for the market to under price the true cost of term conversions.

Conversion Privilege Restrictions

Typically, conversions are permitted only for a specified number of policy years, usually with a maximum attained age. For example, a level term product may restrict conversions to the level premium period or attained age 70, whichever is the earliest. These restrictions reflect the fact that the likelihood of an insured developing an "uninsurable" condition increases with both time since issue (as the benefit of underwriting wears off) and with higher attained age (as a greater percentage of deaths occur from chronic conditions).

Conversion privileges may also vary depending on product design and features. For example, products may not allow conversion privilege while a policy is being paid by a waiver of premium rider during a qualifying disability. Some insurers have different portfolios of term products, with one having more restrictive conversion privileges than the other. Several insurers use an annual renewable term (ART) or other short-guarantee design as a means to attract younger buyers at a low cost. The goal of these designs is converting them to a profitable permanent plan once the policyholder can better afford the premiums. For these plans, conversions are actively encouraged, and conversion credits are often provided for the insured (as a first-year premium discount) while commissions on conversion are given to the agent.

Pricing Impacts

There are two primary ways to cover the additional cost of anti-selective mortality due to term conversions.

1. **Include excess mortality in permanent product pricing.** This choice is popular because level-period term is very price sensitive, and places the anti-selective mortality into the product that is directly affected by the actual increased claims. There are two key difficulties with this approach.

   First, it is difficult to predict exactly what the conversion utilization rate will be on the term product, especially if the conversion privilege extends for many years. Second, it is even more difficult to estimate the volume of permanent product sales that would absorb the excess mortality from these conversions.

   As a result, even with a good estimate of the excess mortality per converting policy, it would be difficult to estimate an actual load. To safely cover this risk, insurers can apply a conservative load to the permanent plans at the risk of affecting their own competitiveness. Using optimistic assumptions to price the conversion mortality load would risk harming the financial performance of the permanent block. Even worse, ignoring conversion mortality in the permanent pricing altogether would risk needing to raise COI rates or cut dividends if excess mortality is extreme. One other option is to develop a conversions-only product. Be mindful that this option may make the conversion alternative less than attractive.

2. **Include excess mortality in the term pricing as part of a cost of conversion.** This has the advantage of aligning the cost of the conversion option to the term product that created the option. This option may include other costs, such as agent compensation for conversions or conversion credits given to policyholders; allowing a proper comparison of profitability across products.

Term products are often price competitive with lower profit margins. In this case it may be difficult to develop a competitive term product that fully absorbs the realistic cost of conversion mortality. This may require the insurer to scale back the availability of the conversion option. One example would be to limit conversions to the first 10 policy years instead of allowing conversions throughout the level period. Another idea is to have two term products, where one has lower premiums but also more restrictive conversion provisions.

Reinsurer Term Conversion Considerations

Reinsurance treaties cover term conversions in one of two ways. A common method is to keep any term conversions in the original treaty at a point-in-scale yearly renewable term (YRT) rate. If this is the case, the reinsurer needs to allow for a higher mortality rate for the conversions than would be used in pricing if the conversions were not reinsured at all. This can show up in rates in a different manner, depending upon whether the treaty is coinsurance or YRT.

- If the treaty is coinsurance, the YRT rates would apply only to the conversions. These YRT rates can fully reflect the extra mortality due to conversions.
- If the treaty is YRT, the extra mortality must be reflected either by increasing the overall YRT rates or using a separate set of YRT rates to be applied point-in-scale to converted policies.

In either case, the extra mortality assigned to conversions may have been underpriced by reinsurers in the past. Like direct writers, reinsurers have had a lack of useable conversion experience data. Reinsurance transaction files in the past had less than perfect indicators about conversion status, whether the treaty was a term treaty keeping conversions or a permanent treaty covering converted policies. As a result, reinsurers, like direct insurers, often priced for conversion mortality without the benefit of solid experience data.

Another common method to reinsure conversions is to cover converted policies as part of the permanent treaty covering the permanent plan to which the policies convert. This becomes problematic for the reinsurer if the cedant has a material amount of term conversions. If the reinsurer already covers all the term products that can convert into the covered permanent plan, it may be sufficient for the reinsurer to review and compare the YRT rates in the permanent pool with the expected mortality used to price the originating term pool(s). If the YRT rates adequately cover the expected mortality including anti-selection upon conversion, then pricing should be adequate.

“ Term conversions have been around for quite some time, yet their impact on product profitability remains a mystery … ”

If the permanent pool covers conversions from term plans not already ceded to the reinsurer, there are three areas of uncertainty in determining the correct load for conversion anti-selection:

- Uncertain mortality from the originating term block of business, both before and after reflecting an adjustment for anti-selection.
- Uncertain volume of term conversions coming from these plans.
- Uncertain volume of originally issued permanent products relative to term conversion volume.

The interaction of these three unknowns can produce a great deal of uncertainty on conversion mortality. If reinsurers can quote a separate YRT scale for converted policies, the risk is confined to the uncertainty on the level of mortality from the originating term plan. If cedants require a single YRT scale covering both original-issue and conversion policies, it may be necessary to put a substantial load on the YRT scale.

Conclusion

Term conversions have been around for quite some time, yet their impact on product profitability remains a mystery for many in life product development. Uncertainty has come from the gaps in experience data, driven by sub-optimal tracking of conversions in years past. Since a substantial amount of conversion experience occurs in later policy years near the end of the level term period, only now are trends emerging on credible company data. It may take several more years for this data to be of sufficient use for an industry-wide study that could be helpful to better benchmark conversion mortality. In the meantime, experience should be gleaned from the best available sources.

For insurers with relatively credible and robust conversion experience, company-specific data should be

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Tony Zajac, FSA, MAAA, is 2nd Vice President, Individual Life with Munich American Reassurance Company. He can be contacted at: tzajac@munichre.com

reviewed. Even if not credible at a granular level, this experience can validate conversion mortality assumptions used.

For insurers selling term life insurance with conversion options, reinsurers can provide objective feedback on assumptions settings based on the experience they have internally. If the direct writing company has even rudimentary conversion experience to share, the reinsurer can compare this experience with their own more credible base, and provide meaningful insight to the direct writer.

Direct insurers and reinsurers have a vested interest in understanding the risks and financial impact of term conversions on their blocks of business. We can expect the knowledge base on conversions to grow as the industry puts proper focus on their impact on product performance. ◻

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