Proposed APF for Fall 2019 LATF Consideration


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Issue Summary—1

- Most term life insurance—whether written on a Group Life chassis or an Individual Life policy form—contains contractual provisions that permit the group certificate-holder or individual life policyholder to convert their existing coverage to a permanent individual life contract.

- In many cases, the insured life has higher expected mortality than a newly underwritten individual life contract and, depending on the expected mortality underlying the valuation of the permanent product, may present the insurer with additional risk.

- As discussed below, the Valuation Manual already requires that if the additional risk is material, it must be reserved for—regardless of whether the “source” term product or the “destination” permanent product is subject to principle-based valuation.

- Because this additional risk is situationally dependent, industry practice varies widely in how the magnitude of this extra risk is assessed and also how a particular insurer might establish an appropriate statutory reserve commensurate with the amount of that extra risk.
LATF informed the Academy’s LRWG that an APF addressing this issue was welcome, and in fact needed, because Life PBR Actuarial Reports to date inconsistently disclosed:

- Whether conversion options are offered by various products
- The amount of excess mortality expected from conversions and whether or not this excess mortality is considered material by the Company’s defined materiality standards
- How this excess mortality has been captured by the insurer within its mortality segmentation
- Whether conversion reserves have even been established
- If conversion reserves are held, how they were calculated
- The “geography” of such conversion reserves within the annual statement
- How this “geography” changes, if at all, at the time of conversion

LATF indicated a desire to have the LRWG propose such an APF by the fall of 2019 so that it might be exposed/adopted during 2019 to signal the will of LATF, be available for “early adoption” with domicile regulator approval, and be included in the 2021 VM.
Add an *explicit* requirement in the **VM Introduction (not in VM-20)** that the insurer must assess whether Group Term Life and Individual Term Life products contain conversion options that may lead to material excess mortality risk and must establish a conversion reserve if such risks are not already provided for otherwise.

This would be part of the VM required language and NOT an optional Guidance Note.
Outline of LRWG Proposed APF on Conversions—2

- Do NOT recommend prescribing a method for calculating conversion reserves due to the diversity of contract provisions and circumstances which may lead to excess conversion mortality.

- Simply require that conversion reserves should account for all material risks and that the method used to determine the reserve be disclosed.
This disclosure is intended to permit regulators, *over time*, to:

- assess the diversity of industry practice
- decide whether existing practices lead to the establishment of appropriate reserves
- And if not—whether prescribed assumptions or methods are needed to lead to industry consistency and appropriateness.
Amend VM-31 to require disclosure within the Life PBR Actuarial Report of:

- Group term and Individual term products with contractual provisions that grant conversion privileges
- A description of specific conversion terms and limitations that might influence mortality risk
- Excess conversion mortality experience arising from both Group and Individual Term, as applicable
- The exposure period over which conversion data was collected and whether contractual conversion terms changed materially during the experience exposure period
- Whether this is the Company’s own relevant, current, credible conversion mortality experience
- Margins for uncertainty and statistical error that have been added to Company experience, their magnitude, and a description of how these margins were determined
Amend VM-31 to **require** disclosure within the Life PBR Actuarial Report of:

- Whether conversion experience was derived from a source **other** than the Company’s experience, and an explanation of why Company experience was not used and why this particular data source was chosen instead
- Margins for uncertainty and statistical error that have been added to this other source of experience, their magnitude, and a description of how these margins were determined
- How this particular source of conversion data is compatible with the contractual conversion terms provided for in the term product converted out of and whether the data source adequately reflects any changes in conversion provisions during the experience period
Further amend VM-31 to **require** disclosure in the Life PBR Actuarial Report of:

- Whether any excess conversion mortality is considered material in terms of the Company’s defined materiality criteria
- Whether conversion mortality is its own mortality segment
- Whether the excess mortality is included within the “mortality level” of other existing mortality segments
- Whether mortality segments including conversion experience have been aggregated and how this aggregation was performed to avoid “distortions”
Further amend VM-31 to require disclosure in the Life PBR Actuarial Report of:

- Where “geographically” conversion reserves have been established, and how this changes over time: e.g., do they reside in reserves for the “source” product until a conversion occurs and are they then transferred to reserves for the “target” permanent product?
- How conversion reserves are calculated for the “source” Group Term and Individual Term products, whether these methods vary by product, and if so, why
- A description of the Individual permanent products provided to the insured as a result of the “conversion”, and whether, and to what extent, reserves for the “target” permanent products already provide for expected excess conversion mortality
- How any additional conversion reserves are calculated for the “target” Permanent products, if it does not already provided for excess conversion mortality itself
Amend VM-50 and VM-51 to **require** reporting to the statistical agent of the Company’s conversion mortality experience so that industry conversion tables can eventually be created for various contractual conversion privileges

**Recommendations:**

- Provide a “phase-in” period for reporting to provide sufficient time for insurers to program their systems in order to comply with required submission content and formats
- Define a materiality level at which an insurer is exempt from conversion mortality statistical reporting to avoid burdening smaller insurers whose experience is not likely to impact the validity and comprehensiveness of these industry conversion mortality tables
- Exempt reinsurers from the statistical reporting requirement to avoid double-counting the experience of direct carriers and also because reinsurers may not be able to identify whether a “newly” assumed reinsured permanent policy actually arose from a conversion
Rationale for Amending the 2019 VM Introduction

- As explained below, the LRWG believes a “plain reading” of the existing 2019 VM Introduction already implicitly requires an insurer consider whether conversion reserves should be established.

- The inconsistent disclosures observed by LATF surrounding conversion mortality and conversion reserves suggests that the existing 2019 VM language may not be clear enough, and as a result the LRWG recommends that the Introduction section of the VM be modified. This is a natural geography for any clarifying edits, as shall become evident.

- The LRWG suggests that any requirements should NOT be embedded within VM-20 because conversion reserves might not involve principle-based reserves (i.e., they might collapse into an NPR reserve, consist of a large fixed NSP, or if the permanent conversion product is in the “Other” category it may be governed by VM-A and VM-C).

- The LRWG recommends this NOT be a Guidance Note so that it has the force of regulation.
Rationale for Amending the 2019 VM Introduction
Tax Considerations from the Academy’s Tax Work Group

Any method that might be prescribed as a result of regulators monitoring disclosed industry practices may want to consider the following feedback from the Academy’s Tax Work Group:

- Separate pre-conversion reserves and post-conversion reserves are currently tax-deductible under a provision for certain additional risks. The Tax Work Group added that the tax code does not define how these additional reserves are to be calculated other than that the reserves are reasonable.

- In order for basic policy reserves to be tax-deductible it needs to be based on an NAIC reserve method. This raised the question for products subject to full PBR of whether the additional risk should be calculated directly in the basic reserve or if it needs to be valued and held separately. This will depend on what is defined in the Valuation Manual to address the additional risk.

- The basic reserve for non-conversion life policies can be subtracted from a recalculated basic reserve with the additional risks of conversion and this difference be used as a separate post-conversion reserve amount.
Section II on Reserve Requirements under Life Insurance Products (Section A) states:

“This subsection establishes reserve requirements for all contracts issued on and after the operative date of the Valuation Manual that are classified as life contracts as defined in SSAP No. 50 in the AP&P Manual, with the exception of annuity contracts and credit life contracts. Minimum reserve requirements for annuity contracts and credit life contracts are provided in other subsections of the Valuation Manual.”
SSAP 50 defines life contingent risks as those that arise from BOTH Group Life and Individual Life

- SSAP No. 50 defines Life Insurance Contracts with life contingencies to include the following contracts:
  - Whole life
  - Endowment
  - Term life
  - Supplementary life
  - Group life
  - Franchise life
  - Universal life
  - Variable life
  - Limited payment
  - Credit life
  - Annuity

Applying this definition, both Group Life and Individual Life contracts are subject to the requirements of the VM.
In the Introductory Section of the VM, there is a subsection “Overview of Reserve Concepts.” This distinguishes between reserves and capital essentially through a “negative principle”:

“Risks not to be included in reserves are those of a general business nature, those that are not associated with the policies or contracts being valued, or those that are best viewed from the company perspective as opposed to the policy or contract perspective. These risks may involve the need for a liability separate from the reserve, or may be provided for in capital and surplus.”
The “Overview of Reserve Concepts” section goes on to include mortality risk as a risk “associated with the policies or contracts,” and this in the view of the LRWG would logically extend to any excess conversion mortality:

“Because no list can be comprehensive and applicable to all types of products, this section of the Valuation Manual provides examples of the general approach to the determination of the meaning of “associated with the policies or contracts” while recognizing that each relevant section of the Valuation Manual will deal with this issue from the perspective of the products subject to that section. Examples of risks to be included in a principle-based valuation include risks associated with policyholder behavior (such as lapse and utilization risk), mortality risk, interest rate risk, asset default risk, separate account fund performance and the risk related to the performance of indices for contractual guarantees.”
The following changes were recommended by the LRWG in a proposed APF to clarify that group certificates meeting certain requirements should follow the same reserve requirements as other individual ordinary life contracts. Items 5 and 6 on the next slide and thus Items 1 and 2 on this slide are relevant here as well.

1) Clarify the minimum reserve requirements for group life and franchise life contracts which, other than the difference between issuing a policy and issuing a certificate, have the same or mostly similar contract provisions, risk selection process, and underwriting as individual ordinary life contracts;

2) Add language to allow application of VM-A and VM-C for these group life certificates prior to 1/1/202x;

3) Add new paragraph, VM-20, Section 1.B, to clarify group life certificates issued using individual risk selection processes, including a definition for individual risk selection process, are subject to the requirements of VM-20;

4) Add guidance note after first sentence in VM-20, Section 2.A.1, to clarify applicability to group life insurance certificates that meet the individual risk selection process definition;
The following changes were recommended by the LRWG in a proposed APF to clarify that group certificates meeting certain requirements should follow the same reserve requirements as other individual ordinary life contracts. Items 5 and 6 on the next slide and thus Items 1 and 2 on this slide are relevant here as well.

5) Modify VM-51 to no longer exempt individually solicited group life and franchise life contracts which meet the requirements and definitions under items (1) and (2) above; and

6) Modify VM-51, Appendix 4, to no longer exempt individually solicited group life contracts which meet the requirements under items (1) and (2) above.
Questions?

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