THE AUDIT AND COMPLIANCE COMMITTEE OF

REINSURANCE ADMINISTRATION PROFESSIONALS ASSOCIATION

PRESENTS

ADMINISTRATION AND AUDITING OF TERM CONVERSIONS

A REVIEW OF INDUSTRY PRACTICES

INDUSTRY WHITE PAPER

2020

Executive Summary

Term life products usually have an option to convert to a permanent life product without underwriting. The administration of term conversions can be difficult to execute and manage depending on the administration system. Understanding the treaty language and how conversions are administered is key to successfully auditing term conversions. The Audit and Compliance Committee completed a study of administration and auditing practices for term conversions.

To that end, this paper begins with recommended treaty language for governance of term conversions from the ACLI Life Reinsurance Treaty Sourcebook (2008 ed.). From there, we share industry practices regarding administration of term conversions, as gathered through several surveys, discussions, and interviews conducted between the years 2013 through 2019. Lastly, for reinsurance companies, we outline best practices to follow when conducting term conversion audits of their external partners' reinsured business.

This paper points out various possible ways that term conversions can be administered and highlights the variations and commonalities in administration. We include discussions and survey results to questions regarding treaty governance, reporting, decision making, and premium calculations. The survey questions shed light on the various administration options. For example, there are several types of treaties that can govern conversions, and several ways that converted policies are reported on transaction and in-force files. The universe of possibilities is beneficial for administrators and auditors to understand as they design administrative and audit solutions. Review of peer responses is beneficial as administrators and auditors balance their organization's specific needs and capabilities against clarity in reporting and communication across our highly integrated industry.

A special thanks to the following members (past and present) of the Audit and Compliance Committee for their time, expertise and contribution:

Carolyn MacPherson (Co-Chair)	Swiss Reinsurance Company Ltd, Canadian Branch
Janice Lawrence (Co-Chair)	Pacific Life Re
Glenn Beuschel	Munich Re Life US
Mary Fadden	Equitable
Eric Lalonde	John Hancock Life Insurance Co
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Bethany Stivenson	Equitable
Lynne Martone (Past Chair)	Swiss Re America Holding Corporation
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Understanding Administration of Term Conversions

1. Industry standard treaty language for term conversions

The ACLI 2008 Treaty Sourcebook information presented below regarding certain plan changes is meant for voluntary use by participants in the life insurance and life reinsurance industry. Approximately fifty (50) industry experts, representing ceding companies, reinsurance companies and retrocessionaires, served on the committee resulting in the detailed content contained in the sourcebook. It is intended as a reference for reinsurance professionals. It is not intended to fit every situation and a company must determine if and how any of these terms relate to the company's specific situation.

ACLI conversion language extracted from *Life Reinsurance Treaty Sourcebook 2008*:

"GENERAL CONDITIONS

Policies that undergo a contractual or noncontractual change of plan to a plan not covered under this Agreement [*select:* shall *or* shall not] remain reinsured hereunder. Policies that are not reinsured under this Agreement that undergo a contractual or noncontractual change of plan to a plan covered under this Agreement [*select:* shall *or* shall not] be reinsured hereunder.

CONTRACTUAL CHANGES OF PLAN

For a contractual change of plan of any Policy, reinsurance of the Policy issued under the new plan will continue under this Agreement in an amount not to exceed the Reinsured Net Amount at Risk prior to such change, except as otherwise provided herein.

Reinsurance Premium for contractual changes of plan shall be calculated using point-in-scale Reinsurance Premium Rates from the original Policy issue date.

If the contractual change of plan results in an increase in the [*select:* Face Amount *or Policy* Net Amount at Risk], such increase shall be underwritten by the Ceding Company in accordance with its Underwriting Guidelines and shall be considered new business under this Agreement. Reinsurance Premium for the increase shall be based on the new issue Reinsurance Premium Rates from the effective date of the increase.

NONCONTRACTUAL CHANGES OF PLAN

The Ceding Company shall treat a non-contractual change of plan of any Policy in accordance with its Underwriting Guidelines. If the Ceding Company's Underwriting Guidelines treat the changed policy as new business, then the changed policy shall be considered new business and shall be covered under this Agreement if this Agreement would otherwise apply to such new business. Reinsurance Premium for

such Policies shall be calculated based on the new issue Reinsurance Premium Rates from the effective date of the change in plan.

For purposes of this Agreement a changed policy shall be considered new business if the Ceding Company:

a. obtains complete and current underwriting evidence on the full Face Amount of the changed policy;
b. pays full normal commissions for the changed policy; and
c. applies suicide and contestable provisions as if the changed policy were newly issued.

Otherwise, the changed Policy shall not be considered new business, and Reinsurance Premium shall be calculated using point-in-scale Reinsurance Premium Rates from the original Policy issue date.

Noncontractual changes of plan of a Policy originally reinsured on a facultative basis, will be subject to the Reinsurer's prior written consent."

Some notes with respect to this sample language were included in the sourcebook for consideration:

"…. Contractual changes include conversions. Noncontractual changes include exchanges and replacements. The Parties may desire to handle contractual and noncontractual changes differently (e.g. contractual changes to a plan not covered under the Agreement could continue to be reinsured while noncontractual changes would cease to be reinsured). The Parties should consider the Ceding Company's administrative capabilities for increases to ensure the increased amount can be reported as new business. If this is not possible, the Parties may consider, for example, whether the combined amount will be treated as new business, based on some level of underwriting, or whether it will be reinsured on a point-in-scale basis……."

It's possible to use this language in its entirety, or in part. For instance, a company might use an abbreviated version of the language that doesn't differentiate between contractual and non-contractual changes, but simply specifies which underwriting criteria to review when determining if a policy change should be handled as new business or a continuation. Generally, term to perm conversions fall under contractual changes that require handling as a continuation.

2. Administration issues that impact term conversions

Results from the October 2013 *Swiss Re Admin Forum* and *Swiss Re Term Conversion Survey* are shown below, along with the results of a November 2019 *Audit and Compliance Committee Term Conversion Survey* of fourteen North American companies that included Direct Writers, Reinsurers and Retrocessionaires.

a) Identify and understand treaty terms for conversions

Question: ***How do you determine the correct reinsurance treaty for reporting the term converted policy?***

Selecting the treaty to administer the term converted policy seems to vary considerably, based on the language in the original treaty. The reinsurance treaty terms and rates to be used for the converted policy can be found in one of the following:

- Original Treaty
- New Plan's Treaty
- The mix of Original/New Treaty
- Special Conversion Treaty

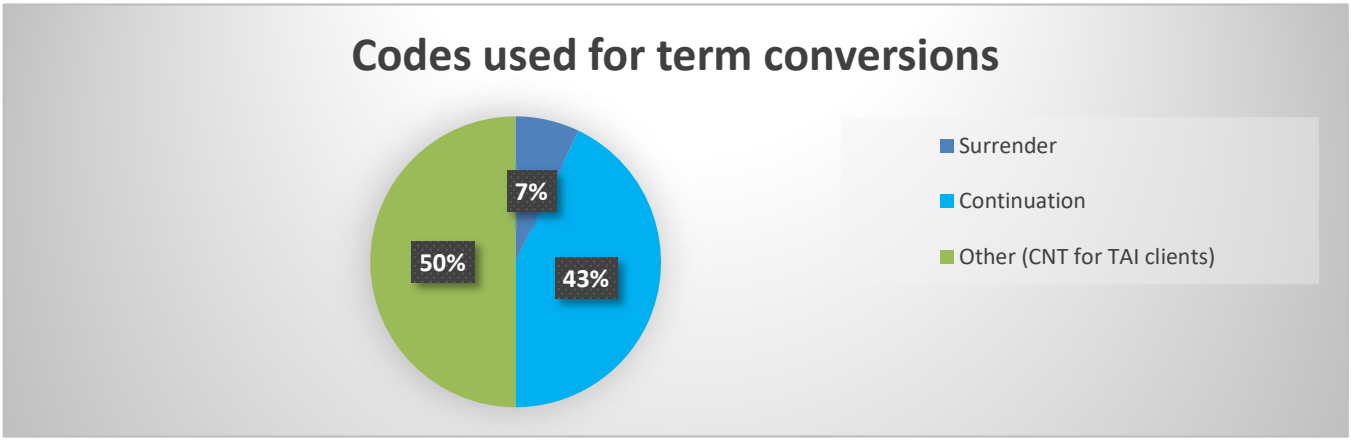
Question: ***Are the reinsurance treaty terms for term conversions and other continuations clear and understandable?***

Most of the companies noted that some of the older treaties can be quite confusing. However, the newer treaties scored high on the very clear side of the scale. Key points highlighted by the Swiss Re Admin Forum are noted below:

- Treaty language can be confusing, thus making it difficult to understand and interpret the original intent of the parties.
- In older treaties, some of the conversion terms are not clearly defined.
- The path to automate processing may prove difficult as a result of inconsistent treaty terms.

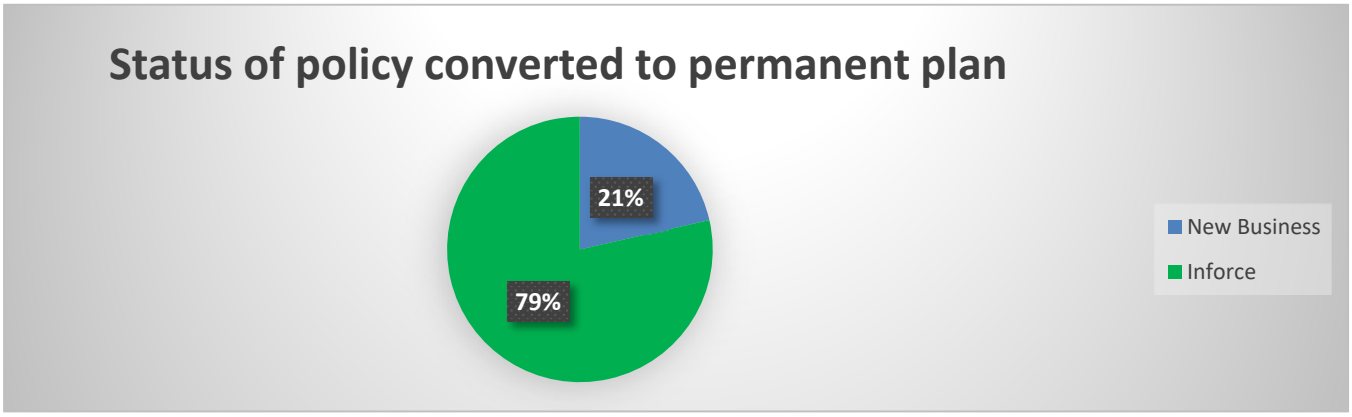
b) Identify and connect a converted policy with the original policy

Question: ***How do you code conversions [of an original policy] in your system, as a Lapse, Surrender, other Terminations type or own code?***



Survey response "Other": *Preferably TAI clients use CNT- but whatever transaction type they send is what we use. This can distort experience studies though.*

Question: ***Once a policy is converted to a permanent plan, do you consider the new policy as "Inforce (continuation)" or "New business"?***

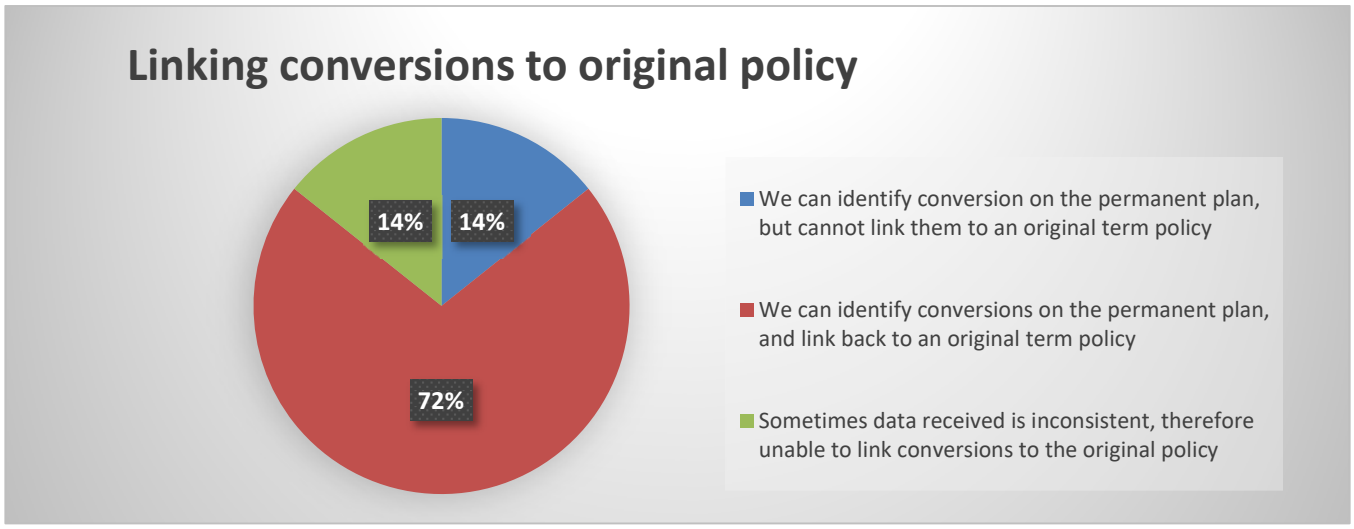


Question: ***How are term conversions [to a new policy] identified on transaction and in-force listings for reinsurers?***

Most companies in the 2013 survey used either an issue type field or a treaty code to flag policies as conversions. However, it was noted that the accuracy of these flags varies greatly in

practice. Probably a result of automated versus manual processing. It is important to distinguish between term conversions and other types of continuations. For example, internal replacements and exchanges that require new underwriting and reinstate the contestable period are usually treated as new business, resulting in a different handling of the reinsurance. Usually, the premium and duration used are different and the risk may belong in a different treaty with a different reinsurer. When not administered correctly from day one, it may be difficult to correct in the future or at the time a claim is submitted.

Question: ***Are you able to link original term policy to converted permanent policy?***



Question: ***What original policy information is provided to reinsurers?***

Most companies in the survey include original policy number, original issue date and issue age/duration. It was also noted that the original policy number can appear on policies other than term conversions, such as replacements or other types of continuations. This highlights the value of the flag addressed in a prior question to distinguish fully or partially underwritten continuations from term conversions.

At times, when some of the original policy information is not included, the reinsurer is compelled to make assumptions as to the missing information. For example, based on experience study information discussed at Swiss Re's Admin Forum:

What is the value of having the original issue date?

Relative to new business policies, conversion policies exhibited one-third higher mortality, while conversion policies with unknown original issue dates exhibited far greater mortality.

This illustrates the value of underwriting selection and the significance of tracking the original issue date. Without the original issue date, unexplained fluctuations in mortality studies can cause issues with reserving, the setting of pricing assumptions, as well as impact the accuracy of premium payments.

c) Calculate term conversion premiums

Question: ***How do you calculate the point-in-scale duration for the reinsurance premiums on those policies that do not convert on their anniversary date?***

Many of the older treaties are somewhat unclear on this point or silent. Methods identified are:

- Method A – This method would keep the original issue date and continue to pay premiums based on the anniversary of the original issue date. Treaties are not consistently clear on this point.
- Method B – This method pays premiums based on rounding to the nearest duration, when premiums are not paid on the anniversary of the original issue date. This assumes that policies are evenly distributed throughout the year.
- Method C – This method pays premiums based on the duration in which the policy converted. This results in premium payments slightly lower than if they had been paid on the original anniversary. For example, if someone converts the day before the 10th anniversary, and the ceding company bases the duration on the duration at the time of conversion, then the ceding company will pay the duration 9 premium again for the second year.

About 50% of the companies surveyed apply point-in-scale by rounding to the nearest duration. Point-in-scale processing was noted as an item that was not clearly defined in several older treaties. Clarity of treaty terms may help to establish more consistent treatment of point-in-scale premiums.

Question: ***How challenging is the process to assign premium rates to the term converted policy?***

Companies in the survey with very manual processes and complicated treaty terms found it more difficult to assign the correct premium rates to converted policies. In general, it appears that the challenge of assigning premium rates is correlated to how automated the process is and the clarity of treaty terms.

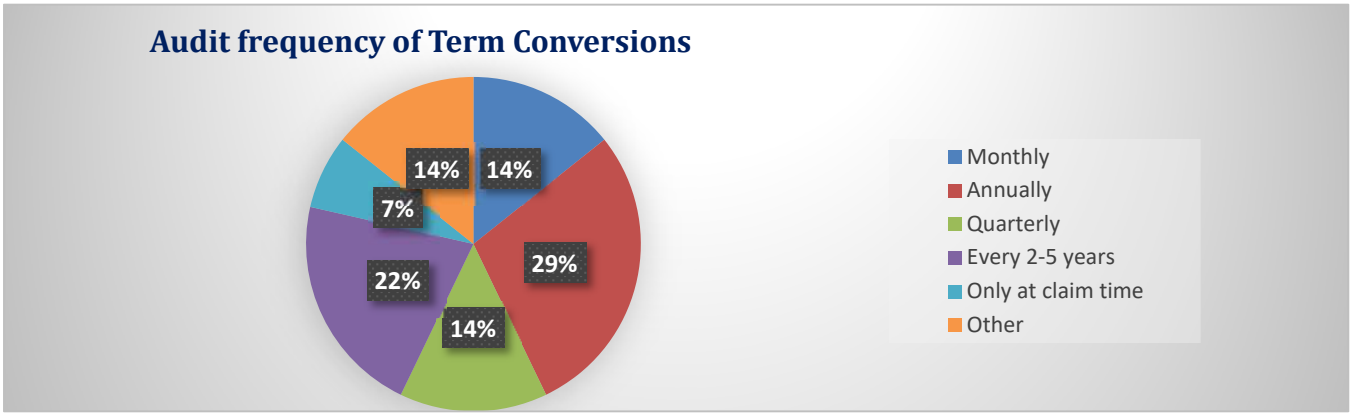
Additional discussions were focused on insurance companies that acquired blocks of business and/or other legal entities. Often these companies are paying the conversion rates that were being paid at the time the business was acquired, however, these companies may not know if

these rates are correct or from what treaty the rates originated. Possible industry solutions are noted below:

- Negotiate a new set of mutually agreeable rates and point all conversions to those rates.
- Recapture conversions when documentation of conversion rates paid is unavailable.
- Partner with a reinsurer to manually research the conversions to validate the premiums paid. May prove to be a time-consuming quest with possible on-site system access or resources required.

d) Term conversion quality assurance

Question: ***How often do you audit reinsured term conversion policies in your company?***

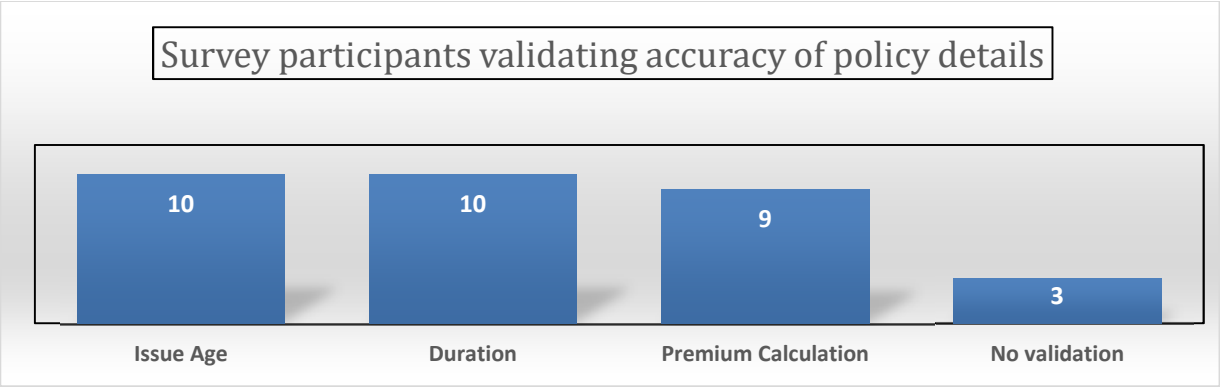


Question: ***If the client does not identify term conversions, how does your company determine them in preparation for an audit?***

Most companies compared original issue dates to issue dates, looking for mismatches. The reinsurance duration value was also compared to the policy duration/year. Additional methods of identifying potential conversions included comparing clients' terminated term products to any new permanent products, whether termination date vs new issue date, or matching face amounts between the old and new policies. If a policy was identified as a conversion minus the original policy's number, searching by name and date of birth was mentioned the quickest way of potentially identifying that missing policy. (Accuracy not guaranteed.)

One respondent stated: "They would get missed", while another stated "that the company would simply ask the client how conversions are identified in their files."

Question: ***Does your company verify the accuracy of issue age, duration, and premium for term conversions when conducting a client audit?***



Guideline & Best Practices for External Audits of Term Conversions

1. **Review in-house data:**

   Gather client reporting information from your company's various functions:

   - Gather the most recent in-force listing and transaction files to complete the audit.
   - Acquire mapping, file layouts and translations of client in-force and transaction data.
   - Identify any known issues with client's reporting of term conversions.

Include transaction files in audit when possible, since transaction files directly reflect the billed premium that is associated with the converted policy.

2. **Review treaties:**

   During review of treaty and amendments, confirm the following:

   - Are term conversions allowed?
   - Are joint conversions allowed?
   - What are the administration rules for conversion?
     - Should premium be calculated point-in-scale?
     - Does the treaty contain conversion-specific premium rates and/or pay factors?
     - Are rates provided in the treaty or referenced in another treaty?
   - Can the treaty accept policies converted from another treaty, or previously not reinsured?

Select treaties that have recently passed the level term period; i.e. look for 20-year term treaties that were executed 20 – 25 years ago.

3. **Review client's data:**

   Review the client's in-force and transaction files as the layout may be different and one layout may indicate term conversions.

   - Determine if term conversions have been identified on the client's data.
     - Client Data Indicators: Treaty Number, Plan Code, Issue Type, Message Field, Transaction Type.
   - Determine if the original issue date and/or conversion date are provided.
   - Determine if the policy duration and/or reinsurance duration are provided.

        - For policies with no conversion indicator, policy issue dates and duration may indicate if it is a policy conversion.
    - Determine if the issue age and/or original issue age are provided.
    - Determine if the age basis has been provided.

4. **Test (Premium/Allowance verification and treaty compliance):**

A) New converted policy

- Calculate duration using original issue date & compare to reported duration.
- Compare the calculated issue age to the reported issue age:
    - Use industry standard for age calculation based on age basis.
    - Example: (Original policy date - DOB)/365.25 rounded to the nearest whole number for Age Nearest, round down for Age Last basis.
    - If NO original policy date provided, use (Policy date – DOB) / 365.25, round to the nearest whole number.
- Compare recalculated issue age against issue type to confirm issue age aligns with continuation or new business coding.
- Ensure face amount on the newly converted policy does not exceed the original policy, unless Treaty/Amendments allow additional coverage/second life via new underwriting.
- Ensure that quota share & retention are correct.
- Ensure smoker class on newly converted policy is matched with original policy unless worded differently in Treaty/Amendments.
- Ensure mortality rating on newly converted policy is matched with original policy unless worded differently in Treaty/Amendments.
- Ensure that the appropriate premium rate has been applied to the determined issue age and duration

B) Original policy

- Verify if the original policy is a full or partial conversion.
- Transactions should happen on the same file so as not to overlap coverage.

Conclusion

The accuracy of term conversion administration relies on the correct interpretation of treaty wording and utilizing an administration system that accurately records and links the original and converted policy details, as well as correctly assigns the age, duration and premium rates at time of conversion.

It is imperative that term conversions are identified and audited in order to validate that they are being administered correctly in accordance to treaty terms. This applies to a company's internal term conversions, as well as term conversions that are reinsured or retroceded, as the case may be.

Source materials used in completing this White Paper:

Audit & Compliance Committee research, discussions and their companies' best practices

Swiss Re Admin Forum highlights of discussions

Swiss Re term conversion survey / October 2013

Audit & Compliance Committee survey/ November 2019

ACLI Life Reinsurance Treaty Sourcebook 2008