Watch Your (Contestable) Step!

Policy contestable clauses allow insurers to balance the consumer’s need for quicker policy issue with the insurer’s need to thoroughly assess the applicant’s risk. If a material misrepresentation or fraud is discovered during the contestable period, the insurer can contest any claim and possibly void a policy during the first two policy years. Because this may subsequently result in significantly lower claim incident rates compared to later years, the impact of the clause upon experience study analysis can be significant. The pricing actuary must therefore understand and account for this effect when analyzing early claims experience. I addressed this topic in an earlier issue of The Messenger*. In the following article, I use SCOR’s proprietary experience study database to delve further into claims patterns during the early policy years.

Experience Database Filters
To create a fairly homogenous and recently underwritten block of reinsured business, I selected the following exposures:

- Exposure years 1/1/2004 – 6/30/2010
- Policy years 1 – 8
- Original face amounts $100,000 – $9,999,999
- All plans of insurance
- Clients with at least 140 claims spread reasonably through policy years 1 – 8
- Standard issues only (no ratings)
- Automatic issues only (no facultative)
- Expected basis is 100% of SOA 2001 Valuation Basic Tables
- A/E ratios analyzed by face amount of reinsurance

I chose the SOA 2001 VBT standard industry table due to its smooth progression of mortality rates during early policy years – making it easy to highlight the contestable period’s impact on paid claims experience.

Pattern of Mortality in Early Policy Years
Figure 1 shows A/E ratios by policy year, revealing the impact of the contestable period. The combined mortality in policy years one and two is 51 percent of the VBT, whereas in years three through eight the combined mortality ratio is noticeably higher at 62 percent of VBT. This can be viewed as an 18 percent reduction in mortality experience due to the elimination of successfully contested claims. There is also a slight increase in the A/E ratios from policy year one to two, implying that insurers are slightly more inclined to contest and void claims in the first policy year. While there is an upward blip in the A/E ratio for policy year three (exaggerated by the downward blip in policy year four), it appears that A/E ratios remain fairly level in policy years three through eight.
Thus, an effect of the contestable clause appears to be a relatively sustained upward step in the level of mortality beginning in policy year three.

Contestable Step by Client Group

Having determined that the contestable clause has a demonstrably real effect on the pattern of mortality experience in the early policy years, it is reasonable to ask if this phenomenon is similar for all insurers. I analyzed the experience for each individual client within my study by comparing the A/E ratio for policy years one and two combined with the A/E ratio for policy years three through eight. In order to normalize for the impact of differences in the absolute level of A/E ratio by client, I divided each A/E ratio by the client’s prevailing A/E ratio for policy years three through eight. Figure 2 summarizes these results. The clients fell into four distinct groups. Group 1 had a large reduction in mortality in policy years one and two, Group 2 had a medium reduction, and Group 3 had a minimal reduction. Group 4 actually had an increase, indicating anti-selective policyholder behavior during the contestable period.

Next, I wanted to determine whether the normalized A/E ratios in policy years three through eight remained fairly constant. Figure 3 shows these results. While there was much fluctuation in the A/E ratios, the trends (indicated by the dotted lines) for the first three groups were fairly flat. The trend for Group 4 (the anti-selection group) was distinctly downward. I attribute this to the wearing-off of the anti-selective behavior.

Application in Pricing

When SCOR’s pricing actuaries analyze a client’s mortality experience, they make adjustments to the data to recognize the effect of the contestable clause. First, they adjust the overall A/E ratio to correct for any policy year exposure bias – a study with exposures heavily weighted in the first two policy years could result in an artificially low overall ratio. Next, they match the actual pattern of mortality due to the contestable step – decreasing the mortality rates in first two policy years and increasing the rates in policy years three and later. Since the level and pattern of mortality varies from client to client, a customized and unique assumption is required for each pricing exercise.*


Groups 1-3 exhibited some reduction in mortality during policy years one and two, ranging from significant to minimal. Group 4 actually experienced an increase, indicating anti-selective policyholder behavior during the contestable period.

Figure 1 - A/E Ratios by Policy Year

The combined mortality in policy years one and two is 51 percent of the VBT, whereas in years three through eight the combined mortality ratio is noticeably higher at 62 percent of VBT. Despite the drop in policy year four, mortality remains fairly level from year three through year eight.

Figure 2 - Normalized A/E Ratios by Policy Year

<table>
<thead>
<tr>
<th>Policy Year</th>
<th>1-2</th>
<th>3-8</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
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</thead>
<tbody>
<tr>
<td>Group 1</td>
<td>56%</td>
<td>100%</td>
<td>108%</td>
<td>101%</td>
<td>96%</td>
<td>92%</td>
<td>120%</td>
<td>78%</td>
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<tr>
<td>Group 2</td>
<td>78%</td>
<td>100%</td>
<td>105%</td>
<td>82%</td>
<td>96%</td>
<td>124%</td>
<td>113%</td>
<td>83%</td>
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<tr>
<td>Group 3</td>
<td>90%</td>
<td>100%</td>
<td>112%</td>
<td>89%</td>
<td>108%</td>
<td>96%</td>
<td>94%</td>
<td>94%</td>
</tr>
<tr>
<td>Group 4</td>
<td>113%</td>
<td>100%</td>
<td>126%</td>
<td>99%</td>
<td>104%</td>
<td>94%</td>
<td>90%</td>
<td>92%</td>
</tr>
</tbody>
</table>

Figure 3 - Mortality Experience by Policy Year

The combined mortality in policy years one and two is 51 percent of the VBT, whereas in years three through eight the combined mortality ratio is noticeably higher at 62 percent of VBT. Despite the drop in policy year four, mortality remains fairly level from year three through year eight.
The trends (indicated by the dotted lines) for the first three groups were fairly flat. The trend for Group 4 was distinctly downward, likely due to the wearing-off of the anti-selective behavior.