Comparing Term Life Insurance Policies

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ABSTRACT

Many financial advisors recommend term life insurance policies to their clients. Unless advisors are well versed, they too often lack a thorough enough understanding of policy options to recommend the best combination of features. The authors begin by describing the most important term insurance options, and then explain how agents can determine the importance of each feature for a particular client, thereby avoiding common mistakes. Selecting term policies is a difficult and time-consuming task, but this article will help many agents and professional advisors make better choices for their clients.

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Introduction

U.S. life insurers sold a little more than four million new term policies in 2017, and the vast majority of the sales involved an agent.[1]

But how qualified are these agents to determine which policy features are best for their clients? In general, they are well-qualified because they have to pass state licensing exams to prove their knowledge, and they usually have several years of experience selling term policies.

However, state licensing exams test mostly basic information, and not the thorough understanding needed by competent professionals. Further, advisors who sell only a few policies each year may not be incentivized to put in the time necessary to develop a deep enough understanding of policy features to make the best decisions for their clients. They can determine the optimal initial maturity, use software calculators to figure out how much death benefit is needed, and make sure the AM Best rating is fine. But understanding conversion features is especially difficult, and that is just one example of the deeper understanding needed to make the right policy choices.

As a result, an uninformed agent will choose the best policy only by coincidence. They will too often fail to consider several important contract features, including the ability to convert term policies into permanent policies and all the complexities associated with doing so. Further, there is a more comprehensive measure of insurers' financial stability than looking at only, for example, the AM Best carrier rating. And many other features may be important for some clients. These additional considerations usually are important enough to affect policy choice.

This article describes the most important factors to consider when purchasing term life insurance policies, describes how to avoid common mistakes, and makes recommendations about choosing the most appropriate policy options. It begins with a brief discussion of the uses of term policies and then addresses nuances in policy features.

Characteristics and Uses of Term Insurance

As its very name implies, term insurance is coverage that will last a stated number of years; that is, a stated term. It is the least expensive type of life insurance per dollar of death benefit, as it is mainly meant to pay death benefits when lives end prematurely, and by many accounts, only about 2 percent of term policies ever pay a death benefit. Accordingly, the vast majority of insureds outlive the maturity of their policies (and are happy they did so). A key characteristic of term insurance is that many insureds are paying premiums for the one unlucky insured who dies, keeping premiums comparatively low.

Most carriers offer level premium policies with maturities of 10, 20, and 30 years. With that being said, a few carriers also offer maturities of 5, 15, 25, and 35 years, and at least one carrier offers a policy called Select-a-Term with maturities available for 10, 35, and any incremental year between 15 and 30 years—a total of 18 maturities. Contrasting with level premium policies are annual renewable term (ART) policies. Denoted as ART or yearly renewable term (YRT) policies, they also are widely available from carriers but less popular than level premium policies. ART policies have unique features: (1) they consist of a series of one-year maturity policies, one for each year of maturity; (2) there is no specified term as with level term policies; (3) the premium increases each year as the insured ages; and (4) every state sets a maximum issue age.

ART premiums usually start out lower than a level premium policy, a potentially attractive feature for clients focusing at the time of purchase on only the smallest premium possible, or who need coverage for only a few years. But premiums increase every year as the insured ages, slowly at younger ages, and exponentially at older ages. They eventually exceed level term premiums and will substantively exceed level rates thereafter, eventually becoming unaffordable at old ages to all but the wealthiest clients. This is not what most clients want, and that's reflected in the life insurance market: Many life insurance companies do not offer ART policies because of low demand. Advisors must be aware that ART policies should be considered for only relatively short time periods with maturities ending long before old age when unaffordable premiums will apply.

Because term insurance is temporary, the most common use of term insurance is to protect dependents by replacing income if a family breadwinner passes away. Such policies protect the financial welfare of children until they no longer are dependents, and may protect dependent spouses until the point they are financially independent. In addition, term insurance often is used to pay off mortgages and other debts upon the deaths of borrowers. Otherwise, surviving dependents will be saddled with continuing debt payments without the decedent's income. In addition, term insurance often is used to satisfy requirements of divorce orders. A divorcing spouse frequently is required to buy enough term insurance to fund future child support payments. Individuals sharing business ownership with a small number of other owners frequently use term insurance to fund buy-sell agreements and key person coverage. If it appears that the uses of term insurance are boundless, that conclusion is correct.

Discussion

Several major considerations dominate term life insurance purchase decisions. The most important are:

1. premiums

2. carrier quality
3. convertibility options
4. underwriting

The following sections describe why each factor is important and what must be considered to make the best choices for client needs.

1. Premiums

A premium is the price of insurance. Applicants want the lowest price, and with all else being the same, the lower the price, the more attractive a policy is. Yet, all else usually isn't the same. For starters, an agent's initial premium estimate likely is based on only a minimal amount of information which may include an estimate of an applicant's overall health status, use of tobacco products, the applicant's self-reported height and weight, and answers to a few lifestyle questions. Based on this abbreviated description of an applicant, a carrier's software will return premium estimates. These quotes are only an approximation pending completion of a much more thorough policy application.

Once an applicant (or an agent working with a client) completes an application, a paramedic examiner will phone the applicant to set up a physical exam. The exam asks many of the same questions as the application, but goes further. Height and weight measurements will be taken, and urine and blood samples will be gathered and tested for various conditions such as cholesterol, illegal drugs, and nicotine. In most cases, the applicant's medical records, both physical health and mental health, are needed, requiring applicants to sign medical releases for all of their medical providers.

All of this information will be used by insurers to underwrite the policy, accept or deny the application, and importantly, set the actual premium. That premium may be quite different than the initial quote which was based on self-reported information, and if it is different, it usually will be higher.

The issue is that a client's initial conversations with an agent are not likely to give the actual premium. More information is needed, and that can be a problem for applicants and their agents. When clients begin the application process, note the work required to fill out a multipage application, and then do a paramedical exam, they almost always have momentum to stay with the application's insurance carrier. They may not keep filling out applications for several other insurers, getting final premium offers from each, and then making the best decision. Instead, more often than not, the first application is the only application. Most applicants will stay with the first carrier they encounter, not realizing it is usually worth the effort to do a more thorough investigation.

Experienced life insurance professionals working for the benefit of their clients will do just that, getting premium quotes from several insurers.

2. Carrier Quality

It is a rare insurance professional who has either the time or ability to analyze the financial health of an insurance company. Required is a deep understanding of accounting, corporate finance, income tax rules, insurance regulations, and so on. Fortunately, insurance professionals do not have to do this work. Instead, they can use the ratings from any of several rating companies.

Many advisors look at any or all of the five most notable life insurance ratings firms: AM Best, Fitch, Moody's Investor Service, Standard and Poor's, and Weiss. That is not as easy as it sounds. Each of the rating companies uses different rating scales. For example, a carrier rated in the fourth highest rating category by AM Best, a rating of A-, is equivalent to between a BBB and a BBB- rating by Fitch, its ninth or tenth highest rating.[2]

Such differences make comparisons among rating firms virtually impossible. Table 1 highlights the lack of uniformity in the number of rating categories among the rating firms.

The problem is rather obvious when advisors are trying to be thorough by using insurer ratings from more than just one rating company to get a better idea of a carrier's financial strength. Not only do the rating codes differ, but the number of rating categories also differs. Rating organizations use their own rating scales, their own populations of insureds, and their own rating standards, often involving hundreds of factors. Comparisons are difficult at best.

Because the vast majority of life insurers are rated at least excellent, apparent differences in financial strength among carriers appear to be minor. A Fitch Ratings study estimated that at least 65 percent of life insurance groups are rated A- or higher by AM Best and that reduces the ability of AM Best to discriminate among insurers.[3]

There is a more thorough approach, however: The Comdex Index. The Index does not rate insurers, but instead is a composite of available ratings from four rating firms: AM Best, Standard & Poor's, Moody's, and Fitch. The composite is available for over 500 life insurers and is expressed as a percentile from one percent to 100 percent, with 100 percent being best. For example, a 100 percent rating means a carrier is in the 100th percentile, or the top one percent of all carriers based on the ratings of the four ratings agencies, while a 20 rating means it's in the 20th percentile from the bottom and is a terrible rating. The Index is calculated and provided by EbixExchange's VitalSales Suite, and is available for a subscription fee.[4]

Comdex ratings, however, are widely available on the internet, and more and more insurers are reporting their Comdex Index values online or in their advertising brochures.

TABLE 1
Comparison of Rating Firms

Rating Company	Total Number of Rating Categories
AM Best[a]	13
Fitch[b]	19
Moody's[c]	21
Standard and Poor's[d]	21
Weiss[e]	15

[a] AM Best's ratings consist of seven financial strength rating categories (A+, A, B+, B, C+, C, and D). Each of these categories include additional rating notches indicated by the addition of a "+" or "–" sign, giving these 13 FSR ratings: A++, A+, A, A-, B++, B+, B, B-, C++, C+, C, C-, and D. ("Understanding Best's Credit Ratings," *AM Best* (January 2, 2019): 21; accessed at: www.ambest.com/ratings/ubcr.pdf.)

[b] Fitch uses 19 rating categories: AAA, AA+, AA, AA–, A+, A, A-, BBB+, BBB, BBB–, BB+, BB, BB–, B+, B, B–, CCC, CC, C. ("Not All Insurer Financial Strength Ratings Are Created Equal," *FitchRatings* (July 2016); accessed at: https://www.fitchratings.com/research/banks/not-all-insurer-financial-strength-ratings-are-created-equal-12-07-2016.)

[c] Moody's insurance company ratings consist of nine categories: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, and C. In addition, except for Aaa, each of these categories may have the number 1, 2, or 3 assigned to add precision, resulting in ratings of Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca, and C. Although C sounds okay, it is a failing grade from Moody's. ("Rating Scale and Definitions," *Moody's.com;* accessed at: moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf.)

[d] Standard and Poor's uses the following ratings: AAA, AA+, AA, AA–, A+, A, A–, BBB+, BBB, BBB–, BB+, BB, BB–, B+, B, B–, CCC+, CCC, CCC–, CC, C. ("S&P Global Ratings," *S&P Global* (October 31, 2018); accessed at: standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352.)

[e] Weiss Safety Ratings (for banks, credit unions, and insurance companies) are A+, A, A-, B+, B, B-, C+, C, C-, D+, D, D-, E, F, and U. An unrated insurer is assigned a rating of U. ("Two Kinds of Weiss Ratings," *Weiss Ratings;* accessed at: weissratings.com/help/rating-definitions.)

Agents sometimes try to convince potential applicants to do business with the companies they represent because their insurers have Comdex ratings greater than the 90th percentile. That argument is a stretch. While ratings that high are outstanding, there isn't much separation between 98 and 85. In the authors' experience, a carrier with a Comdex rating of 85 or above is a strong carrier, and there is little need to be concerned about financial trouble with any company rated this high. This value admittedly is subjective and should not be used as an inflexible rule for choosing or rejecting carriers.

Agents seeking term insurance policies at an affordable rate for a specific insured individual may not be able to find a carrier whose Comdex rating is at least 85, and at the same time offers a policy with the unique coverages a client needs. For example, a client with diabetes, or who is significantly overweight, is a smoker, or participates in actuarially dangerous avocations may be rated or rejected by all carriers with a high Comdex rating. Or the client might need a certain product feature, or unique contract language. There is now a good rationale for considering a carrier with a lower Comdex Index value.

3. Convertibility Feature Flexibility

Convertibility features can be every bit as important as price and carrier quality when choosing a policy. Yet, too many financial advisors ignore convertibility or don't give it enough attention. Convertibility features allow policy owners to convert their term policies into permanent policies from the same insurer, using their term policy's original health rating. This feature becomes very valuable if the insured is no longer insurable, or is insurable at an unaffordable premium, yet still needs life insurance.

The following example helps provide a better understanding of why this feature can be critically important. A 68-year-old woman is 19 years into a 20-year term policy and learns she has a terminal cancer that likely will result in death in 3 to 5 years. Clearly, if her policy were convertible to a permanent policy and she could afford it, she would convert to continue coverage, guaranteeing the death benefit would be paid to her beneficiary. But without a convertibility option, she cannot convert to a permanent policy, and her poor health likely makes her uninsurable. She likely would die after her term policy expires, and her beneficiary would receive nothing from her life insurance.

There is wide variation among insurers as to whether a policy is convertible, the number of years for which the conversion feature applies, the types of permanent policies into which term policies can be converted, and whether second-to-die or partial conversions are allowed. The following summarizes what an advisor needs to know about these options.

Is There a Convertibility Feature?

Most term insurance policies have a convertibility option, but not all of them. There is no fee for conversion, though some insurance companies have differing premiums for products with differing conversion features. A client's premiums will increase considerably after conversion due to the insured's older age and the fact that the insured will have a much more expensive permanent policy. All else being the same—and again, all else is seldom the same—a policy with a conversion feature is better than one without.

Length of Feature

If competing policies are convertible into permanent policies at any time during their terms, the length of the convertibility feature is not relevant. But often, competing policies do differ significantly as to the number of years for which conversion is permitted.

Policy premiums and the length of convertibility options aren't necessarily correlated. There is little logic to this. A policy with the lowest premium may have the longest convertibility period, and the reverse is also true: A high premium may accompany a short convertibility period. Advisors have to check this feature thoroughly.

The length of the convertibility period usually varies among policies. Conversion may be permitted only during the first few years, or for the policy's entire life. The feature also will have a maximum age at which the insured can convert. Usually the maximum age will be at least 65 to 70 years old, but can be as old as 75 to 80 years. In general, the longer the convertibility period, the more attractive the policy is for insureds. Finally, the longer a policy's initial term, and the older the client, the more important the option becomes. Both of these characteristics increase the likelihood insureds will develop serious medical issues, making conversion desirable.

Some insurers offer extended conversion option riders for an extra premium. As the name implies, the rider extends the number of years during which a policy can be converted into a permanent policy. For example, a 15-year term policy could be convertible within only the first 5 years. If an insured develops a serious health issue after the 5th year, it will be too late to convert. Buying the rider when the policy is purchased will help alleviate this risk, making the rider one more feature agents must weigh when selecting term policies. Typically, such a rider will increase initial premiums modestly, often by only a single digit percentage.

The following example should be considered. A 50-year-old female needs a 20-year term policy with a $500,000 death benefit. One carrier offers a conversion feature that expires after 7 years, when she will be 57. The annual level premium is $864. The same carrier charges an annual premium of $919 for a 10-year conversion option to age 60. Does it make sense for the applicant to pay the difference, $55 extra per year, for 3 more years of protection? That is an important decision for clients and their agents. Older clients usually favor the policy with the 10-year feature if they understand what they are being offered. Yet, it is commonplace for policyowners to discount the importance of the convertibility feature when policies are purchased. Some agents may be reticent to show the higher premiums for fear of losing the sale.

If this woman bought the policy with convertibility only to age 57 rather than 60, and at age 59 finds out she is expected to live only 2 or 3 more years, it is too late to convert. Both she and her agent likely would regret not purchasing the policy with the 10-year conversion option.

Continuing with the example, the same woman has made it past her 59th birthday, and had originally purchased the policy with the convertibility option for 10 years, to age 60. She would convert immediately upon learning of the serious health diagnosis. After conversion, she would have to pay relatively expensive permanent life insurance premiums until her death, but she would remain insured.

Finally, it could be supposed that she had purchased a policy with a different term and with a conversion option expiring when the policy matures at age 70. She might be able to delay conversion until her health seriously deteriorates—perhaps 2, 3, or more years—and continue to pay relatively inexpensive term premiums. Delaying conversion to a permanent policy will save her a significant amount of money—the difference between term and permanent premiums over perhaps several years.

Life insurance applicants and their agents never know what the future will bring. It is prudent, then, to select term policies with the longest convertibility feature, especially given that the presence of this feature doesn't seem to have close correlation with policy premiums. Though it might be important at any age, this general rule should be followed: The older the client, the more important a convertibility feature becomes.

Convertibility Product Options

When purchasing a term policy, agents and their clients also must pay attention to the type, or types, of permanent policies allowed at conversion. Many policies allow conversion into only traditional whole life policies which may, or may not, be competitive with similar policies from other insurers. Others offer insureds many choices from traditional whole life and universal life to securities-based products and guaranteed universal life.

An actual example helps illustrate this. A client purchased a relatively inexpensive $1 million term policy with a conversion option until age 75. He bought the policy from his professional association, and chose to do so because the annual premium was only $435, a little lower than the cost of term policies from other insurers not associated with the professional association. What could go wrong?

That was years ago, and he is now 64-years-old and uninsurable. He would like to continue coverage from his association policy beyond age 75. If he converts his term policy, however, the insurer offers only one conversion option—a permanent policy with an outrageous annual premium of $44,000. This is an example of a terrible conversion option. Had the insured initially purchased a nonassociation term policy in the market, the annual premium after conversion could have been as low as $16,000. That premium savings—$28,000 per year—makes the advantage of saving a few dollars per year when the association's policy was initially purchased seem foolish.

While this professional association policy provides a vivid example of a terrible policy, many insurers offer much better conversion option choices. For instance, some carriers offer conversion to any permanent policy in their portfolios of policies at the point of conversion. Other carriers offer conversion to a wide portfolio of policy choices in the early years of a policy's term, but a more limited portfolio later on.

In contrast, some big name and competitive carriers offer conversion only to a highly priced product no one would buy unless backed into a corner with no other options. Because it is impossible to know at issue which type of policy will be best for any particular client who might want to convert, a general rule is that agents should guide applicants to policies offering the widest variety of policy types at conversion.

Convertibility by Contract versus by Practice

In recent years, there have been numerous examples of carriers terminating or restricting conversion features not codified in policy language; that is, not specified by the contract. In the industry, this is known as "by contract" versus "by practice." By contract means the policy language spells out the maximum number of years and types of policies into which term policies can be converted in the future. Less valuable to insureds is by practice, meaning an insurer has a history of allowing conversion into certain types of policies, but that practice isn't guaranteed for the future; that is, it isn't written into the policy.

Why might a carrier change its past practices and no longer allow a particular convertibility option? One reason is the development of the life settlement industry. Rather than let a term policy end at maturity, older policyowners with severe health issues likely will convert to a permanent policy, retaining the option to sell the new policy to a broker. Insurers hate this, and one way they push back is to restrict or eliminate the ability to convert if the option is not written into policy language.

Another reason for restricting by practice options is to reduce expenses as pressure mounts to generate better income. After all, exercise of convertibility options exposes carriers to severe adverse selection. Policyowners who convert often do so because they have severe health issues. Those without such issues likely are still insurable at reasonable premiums, lessening their incentives to convert. Insurers end up with adverse selection which leads to higher mortality expenses, and sometimes they react by restricting conversion options.

It is generally a good idea to buy policies from companies offering contractual rights—by contract—to convert to any permanent policy the company offers at the time of conversion. After all, no one knows in advance whether the convertibility feature will be needed, or if so, which type of permanent policy will be best at the time of conversion.

Second-to-Die and Partial Convertibility Options

Another conversion feature—second-to-die convertibility—may be a valuable option for married couples. When this feature is available, insurers allow a policy on two individuals to be converted into a second-to-die or survivor policy on both. Furthermore, some will allow conversion to a death benefit double the lower amount. The following example shows why this feature could be valuable.

A husband and wife each purchased term policies from the same insurance carrier when they were 25 and starting a family, with each spouse named as the beneficiary of the other. The husband purchased $5 million of death benefit, while the wife purchased $10 million. These policies are convertible to second-to-die policies at twice the lower amount of $5 million. If this couple lives to the ages when individual term insurance is no longer needed, they have the option of converting their policies for up to $10 million of second-to-die coverage (twice the lower amount of $5 million). This option could be very useful for possible estate tax liquidity needs, for funding a favorite charity, or perhaps for funding a family foundation. As always, maximum flexibility is desirable.

Finally, insureds sometimes want to convert only part of their term policy's death benefit. For example, a woman has a $1.5 million term policy and wants to convert $500,000 into a permanent policy and leave the remaining $1 million as term coverage. Some insurers won't allow splitting the policy, while other will. And years later, she might want to convert another $500,000 into a permanent policy. Neither the client nor the agent could have predicted the need for splitting when the policy was initially purchased. The possibility of this change of plans reiterates a main point of this article: Because no one can accurately predict the future, the full range of convertibility features should be discussed with clients. And those that might be needed, or whose cost is inconsequential, should be purchased.

4. Underwriting

Independent agents will go to the market to find the best carriers and products for the circumstances. It is important to understand just how niche-oriented the market is and how seemingly unimportant factors will make a meaningful difference in premiums. This is demonstrated with the following example.

Two wealthy business owner brothers—aged 44 and 46—with the exact same health status, same parents, and same siblings, each sought two $10 million term policies for buy-sell plan funding. Their agent found coverage for the 44-year-old brother for $8,600 per year per policy, but the best the agent could find for the older brother was $10,200 annually per policy. The difference—$1,600 per year per policy—surprised the agent. Certainly the risk to insurers between 44 years old and 46 years old isn't much of a concern. But once the brothers reach their 60s (20 years into the contract), the 2-year risk differential becomes more significant, and that risk causes the premium differential. The carrier offering the lowest cost policy to the 44-year-old was only the 11th lowest cost for the 46-year-old. The 2-year age difference significantly increased the policy premiums, and also changed the carrier from lowest premium to 11th lowest for the slightly older brother. The brothers ended up with four policies—each from a different carrier—to best fit their needs.

As mentioned, the insurance market is more niche-oriented than most people think. The smallest details can make a difference in premiums and drive agents to various insurance companies offering specific options. That happens because different insurance companies look at different medical issues or impairments differently. One insurer might be more liberal regarding height versus weight parameters or lab results. Another might be more aggressive regarding marijuana usage, sleep apnea, psychological issues, and medications.

Even if an applicant is perfectly healthy, family history can play a role. If a parent or sibling experienced cardiovascular or cancer history prior to age 65, many insurers will disqualify applicants from the best underwriting classes, but others won't. Some carriers will move an applicant to a lower rating class if a parent or sibling has been diagnosed with a serious health issue, while others will reject applicants only if the serious health issue resulted in death.

Foreign travel may be a stumbling block, depending on the destination. Dangerous avocations such as deep scuba diving, skydiving, and racing generally result in increased premiums. But again, one insurance company might place more of a risk premium on these avocations than another.

The price differences between preferred best, preferred, standard, and rated cases can be significant. A standard rating may cost twice that of a preferred rating and three times that of a preferred best rating. These differences often are significant enough to make it worthwhile to push for the best outcome by checking several insurers.

The point is that the slightest difference among clients can make major changes in premiums and carriers. Agents and advisors must be aware of the impact on underwriting these slight differences can make, and then be prepared to check out several carriers to ensure they are doing a thorough job for their clients.

Summary

This article summarizes key term life insurance features, details each feature, and describes how to incorporate each feature, and feature options, into decisions about the most appropriate polices to fit clients' circumstances. It is not a simple process, and by implication, the process is too difficult for casual applicants wishing to buy term policies using online premium quoting sites. Informed agents bring value to their clients by sorting through the vast array of policy options and choosing the best combinations for the circumstances. They earn their commissions by adding that value.

Given a choice, here are the features serving as a good general guide for choosing a term life insurance policy:

- Recommended carriers should have a Comdex Index percentage of at least 85 percent, unless there is a good reason to consider a carrier with a lower value.
- Term policies should be convertible into permanent life insurance, and the longer the conversion feature, the better.
- The more types of permanent policies the convertibility feature allows, the better.
- Once policies offering these features have been identified, the lower the premium is, the better.
- Policies allowing partial and multiple conversions and death benefit reductions are preferable to policies that do not.
- Conversion and any other policy change features by contract are preferred over conversion by practice.
- Because the slightest policy feature or applicant characteristic can have significant effect on premiums from one insurer to another, agents need to thoroughly check with several carriers.
- And perhaps most important, agents must thoroughly read the policies they sell. As this article highlights, wording can be critically important to a client. ■

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