Surrenders and Alterations

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Life insurance contracts are written for very long terms, often several decades, and it is common for the insured person’s circumstances to change during that time, causing them to request a change in the terms of the contract. Commonly requested alterations include the following.

- The surrender (that is, immediate cessation) of a savings contract, such as an endowment policy. Under such contracts, a fund is accumulated, and on surrender, it is usual to pay an amount to the policyholder representing the return of part, at least, of this fund; such a payment is called a surrender value or cash value.
- The alteration of a savings contract to be paid-up. The contract remains in force but the policyholder pays no further premiums, and the amount of the benefits (life cover and maturity value) is reduced appropriately to the paid-up sum assured.
- A change to the level of premium payable in future, with a consequent alteration of the benefits (paid-up policies being an extreme case), or vice versa.

Only savings contracts, as a rule, have surrender values. Under pure protection contracts such as term insurance, no great reserves are built up, and if the policyholder stops paying premiums, the life cover usually runs out very soon, and the policy is said to be forfeited. Contracts may have nonforfeiture provisions, under which life cover may be kept in force for a period after the policyholder stops paying premiums, that are paid for by drawing upon the policy reserve. Often, the policyholder may be allowed to reinstate the policy by paying the missing premiums plus interest and, if too much time has elapsed, providing evidence of good health. See [2, 3, 5], for more details.

We also use the terms lapse and withdrawal to describe a policyholder’s action in terminating a contract, and the rates at which this occurs among the body of policyholders may be called lapse, withdrawal, or surrender rates, though the latter usually implies the payment of a surrender value.

In many jurisdictions, endowment policies must be granted surrender values on a guaranteed scale, perhaps after paying premiums for a number of years, and this is a valuable option against the issuing company (see Options and Guarantees in Life Insurance). Such guaranteed surrender values may constrain the investment policy of the insurer severely because the maturity dates of all its savings contracts are potentially very short. They are, perhaps, still consistent with systems of insurance regulation (see Insurance Regulation and Supervision) based on prudent first-order bases (see Technical Bases in Life Insurance) and conservative investments, but they would pose a very great mismatching risk to insurers who depart from this model in order to take advantage of long time horizons to achieve high returns, by investing in equity-type assets. These developments have tended to occur in countries where regulations do not require surrender values to be guaranteed, such as in the United Kingdom. Even in these countries, however, marketing needs have led to policies that effectively do have guaranteed cash values; for example, endowment policies intended to build up a retirement fund may have a range of maturity dates.

However, freedom from guaranteed surrender values need not be good for all policyholders for several reasons. First, lapse rates are very high. Table 1 shows the results of a survey of persistency published in 1998 by the Personal Investment Authority in the United Kingdom [6]. It is clear that the most significant demographic factor in life insurance is not mortality, but surrender; in many cases, a minority of policies originally taken out reach their intended maturity date. This raises serious questions about the suitability of many policies for the people to whom they are sold, and therefore the methods used to sell them, and the methods of remuneration of those doing the selling, such as high commissions at the point of sale. Second, surrender values can be very low, especially at early durations, if they are calculated retrospectively in order to recover high selling costs, including commission. And if surrender values are set so that the insurer recovers some profit from the sale, such high rates of surrender as are shown above mean that surrendering policyholders may subsidize maturity values greatly. It can be argued that this is fair, since to surrender a policy is to breach a contract, but this view is probably no longer acceptable to regulators or courts.

One reason for surrendering a savings contract may be that the policyholder needs the money. An alternative remedy may be to obtain a loan from
the insurer, secured upon the surrender value of the policy. The loan becomes an asset in the insurer’s balance sheet, and the policyholder pays interest upon the loan at a rate sufficient to fund the proper development of the reserve. This arrangement has the advantage of keeping the life cover in force. Another alternative, if the insurer offers rather low surrender values, is to sell the policy in a traded endowment market, if this operates in the relevant jurisdiction (as is the case in the UK, for example). The buyer undertakes to pay the premiums, and takes over the entitlement to any benefits.

Under unit-linked contracts (see Unit-linked Business), the surrender value ought, in principle, to be determined by the value of the units allocated to the policy on the date of surrender, and hence be transparent. Similarly, the paid-up benefit is simply the result of leaving the same units to accumulate to the maturity date. However, this assumes that the charging structure of the policy closely matches the incidence of the actual expenses, so that the effect of surrenders on the insurer’s finances is relatively neutral. Many charging structures do not match heavy initial expenses at all closely (e.g. allocating a high proportion of all premiums to units) requiring the use of a surrender penalty, which is a scale of charges to be deducted from the value of units upon surrender. Unitised with-profits contracts (see Participating Business), similarly, may allow the face value of units to be reduced on surrender, to reflect market conditions (called a market value adjustment). In the United Kingdom, consumer-driven regulation (and adverse publicity) is gradually removing life insurers’ immunity from guaranteed surrender values.

Under traditional life insurance contracts, there are two basic approaches to dealing with surrenders and alterations. Both equate the value of the terms to be offered in future with the current value of the policy, giving an equation that can be solved for an unknown premium or sum assured. It is clear that the first of these quantities must be evaluated prospectively, including the cash payment of a surrender value as a limiting case. The second of these quantities, however, may be evaluated either prospectively or retrospectively [4].

- The prospective approach takes a prospective policy value under the original policy terms as the starting point. Under with-profit policies, this might include the value of the reversionary bonuses already declared. The basis of valuation need not be the same as that used for the insurer’s published reserves, for which very different considerations apply. Initial expenses may be allowed for by valuing an adjusted premium, that includes an explicit loading for the recovery of those expenses; see [1] for details of such adjustments in the United States of America, for example.

- The retrospective approach takes a retrospective accumulation of premiums less expenses and claims costs (similar to an asset share as the starting point. This has two advantages: (a) it allows more accurately for expenses in the early years, which may not be reflected at all closely in a prospective policy value, especially one with no Zillmer (or similar) adjustment (see Valuation of Life Insurance Liabilities); and (b) it may be a better reflection of the true policy value over longer durations, if the insurer employs a system of terminal or final bonus.

There are many practicalities to be considered, such as the treatment of the expenses of alteration and future renewal expenses, or the treatment of attaching bonuses; see [2, 3, 5], for a detailed account. Before computers were widely available, alterations, like many other computations, might involve some simple approximations; for example,
it was common to use proportionate paid-up values, where the paid-up sum assured was that proportion of the full sum assured that was equal to the proportion of all the premiums that had been paid.

Surrender values, especially if guaranteed, have a bearing on the level of reserves that must be held. Skerman’s original five principles [7], widely applied in practice, were extended to six, with the addition of a principle that the reserves held should be sufficient to cover any surrender values that might be payable. Under unit-linked policies, several methods of reducing the reserves to allow for initial expenses have been used, such as actuarial funding or negative non-unit reserves (broadly equivalent to Zillmerizing). An integral part of any such scheme is a scale of surrender charges that ensures that the surrender value does not exceed the reserve actually held.

References