On August 9, 2011, SCOR SE, a global reinsurer with offices in more than 31 countries, acquired substantially all of the life reinsurance business, operations and staff of Transamerica Reinsurance, the life reinsurance division of the AEGON companies. The business of Transamerica Reinsurance will now be conducted through the SCOR Global Life companies, and Transamerica Reinsurance is no longer affiliated with the AEGON companies.

While articles, treaties and some historic materials may continue to bear the name Transamerica, AEGON is no longer producing new reinsurance business.

Archive Materials

Lapse Effects on Level Premiums

Reprinted from the December 2008 Messenger newsletter

When level premium term insurance first became popular, the industry recognized two long-term risk factors – mortality and persistency. Life insurers understand mortality. Lapses, however, driven by policyholder behavior, are more uncertain and can impact profitability throughout the life of the policy.

If lapses are too high in the early years of the level term period, profitability will be reduced due to the smaller premium flow available to amortize issue expenses. If lapses in later durations are too low, there is less reserve released than expected. This reserve release helps offset the increase in mortality compared to level premiums.

Another important lapse event occurs at the end of the level premium period – the so-called “shock” effect. Lapses can increase significantly as the level premiums jump to a high yearly renewable term (YRT) scale. What can happen? What have we seen and what can direct writers do about it?

We are beginning to see the first wave of 10-year level premium term products reach the end of the guarantee period. Lapse rates over the past decade have been less than our clients expected, raising concerns about the impact of the shock lapse. In some cases, the deferred acquisition cost (DAC) balance is higher than originally expected. If shock lapses are greater than originally anticipated in the pricing, issuers of these policies may experience earnings volatility as the higher DAC balance is written off quicker than expected.

One possible way to better realize the value of this business is to recognize the relationship between end of level term premium (EOLP) lapse rates and mortality deterioration and encourage healthier lives to keep the policies they have. The first question is how to deal with the shock lapse.

One key assumption used in modeling this business is policyholder behavior during the first year after EOLP. It is generally assumed that policyholders in good health will promptly acquire more affordable coverage elsewhere, some perhaps paying several months of a high ultimate premium while shopping for a new insurance policy. By ignoring
these healthy policyholders who temporarily pay this higher premium, the company may be overlooking a significant source of profit.

In contrast, it is assumed that impaired lives continue paying the greatly increased premiums, because they expect their beneficiaries to collect on the policy soon enough to make keeping the policy economical for them. Also, these higher rates may be cheaper than a new policy due to their poor health. Worse, replacement coverage may not be available at any price.

Some insurers may encourage healthier yet older lives to update their coverage with a new policy, one reflecting their older attained age and underwriting status. However, in doing so, the issuing company incurs a new set of commissions and underwriting expenses, and there is no guarantee that these policyholders won’t seek coverage elsewhere.

Reducing the multiple of level premium applied in the post-EOLP period has a strong influence on policy retention. When the premium multiple is low the economic incentive for healthy lives to replace their policies is reduced and they lapse at a slower rate. This is significant because any increase in the persistency of healthy lives beyond the level premium period can substantially improve overall profitability.

Impact of Premium Multiple on Policies Retained in Post Level Period

The percentage of policyholders retained through Policy Year 12 (following a 10-year level term period) declines as the multiple of level term premium applied is increased. A lower premium multiple would retain a higher percentage of lives and presumably a higher proportion of relatively healthy lives as well.

The second concern is what to do about the DAC impact. It is understood that DAC cannot be unlocked nor DAC assumptions restated, unless future profits are insufficient to amortize the remaining balance.

While DAC balances can be written off faster than anticipated due to higher than expected post EOLP lapses, it is also possible that DAC balances may be written off faster due to the influence of modal premiums. Healthy lives paying annual premiums, for example, may go ahead and pay the first high YRT rate just out of “momentum.” These lives will persist for the entire year until the second, even higher YRT rate is due, at which time they lapse.

Lapse rates and (consequently) DAC amortization for that first year will be artificially low. However, if there is a large percentage of monthly mode premiums, the healthy lives may pay only one or two months of modal YRT rates before lapsing. This will force a rapid decline in the DAC balance during the first few months after EOLP, which may create an unacceptable pattern of earnings within the year.

An inforce reinsurance transaction may be one way to mitigate the effect of a rapid amortization of DAC and realize the value on the block of business. Letting a reinsurer assume the block would allow the direct writer to receive a ceding commission, in effect monetizing the DAC balance and locking in the value for the direct writer. At the same
time, the assuming company could reset the DAC assumption based on current knowledge, creating a smoother pattern of earnings.

It is often assumed that lowering post-EOLP premiums will create losses due to a mismatch between the YRT rates and mortality. However, if the lapsing lives are assumed to be those that can find acceptable coverage elsewhere, then retaining these higher quality lives by moderating the post-EOLP jump in rates should reduce mortality deterioration.

Even in cases where this proposal may be unsuitable, the life insurer still has the option of reducing earnings volatility and capturing some portion of the DAC by ceding the block of business to a reinsurance partner.

Transamerica Reinsurance has the expertise to help its clients manage the particular mortality and lapse risks associated with the post-EOLP period in order to mitigate earnings volatility and help life insurers manage the impact that shock lapse events can have on their DAC balances.