7.8 Lapse risk

Q84 Section 7.8 Are there any comments on Lapse risk that the IAIS should consider in the development of ICS Version 2.0? If "yes", please explain with sufficient detail and rationale.

Organisation	Jurisdiction	Confidential	Answer	Answer Comments
Canadian Institute of Actuaries	Canada	No	Yes	Mass lapse assumes flooring based on homogeneous risk groups—this implicitly assumes perfect policyholder behaviour selecting against the insurer based on moneyness, level of reserves, etc., which in practice is overly conservative.
China Banking and Insurance Regulatory Commission (CBIRC)	China	No	Yes	We suggest that the IAIS continue its current experience-data-collection exercise, set risk parameters based on the proper experience of each market if available, and update regularly when there are significant experience changes.
European Insurance and Occupational Pensions Authority (EIOPA)	EIOPA	No	Yes	The current stress levels are largely based on expert judgement and from our experience tentatively too low. We prefer to base the factors on reliable calibration approaches.
Insurance Europe	Europe	No	Yes	Policyholder options are included in the lapse risk definition under the current ICS specification. Policyholders may exercise different kinds of options based on product features including partial withdrawals. As such, there is a risk of expected changes to the rate at which policyholders exercise their option and the extent to which such withdrawals are taken at the optimal level. However, the current technical specification is not clear on the strength of the shock required to assess the risk of unexpected utilisation or partial withdrawal rates because the level lapse stresses are not designed to reflect risks associated with utilisation and partial withdrawals. Insurance Europe believes this should be addressed.

				Furthermore, Insurance Europe notes that the application of homogenous risk groups within the mass lapse stress is excessive. Assuming that all policyholders can value the moneyness of the insurer's obligation towards them (using a valuation basis such as ICS) and that policyholders behave in ways that are most onerous to the insurer, rather than adhering their own needs or circumstances is unrealistic. Finally, Insurance Europe believes offsetting effects should be considered. The capital charge for lapse risk should be determined at entity level and not at the level of homogeneous risk groups (see paragraph 577 of FT specifications).
Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Germany - BAFIN	No	Yes	The current stress levels are largely based on expert judgement and from our experience tentatively too low. We prefer to base the factors on reliable calibration approaches.
Global Federation of Insurance Associations	Global	No	Yes	GFIA would ask the IAIS to share its lapse risk calibrations with stakeholders; this will better enable them to propose specific solutions to lapse risk issues. Policyholder options are included in the lapse risk definition under the current ICS specification. Policyholders may exercise different kinds of options based on product features including partial withdrawals. Therefore, there is a risk of expected changes to the rate at which policyholders exercise their option and the extent to which such withdrawals are taken at the optimal level. However, the current technical specification is not clear on the strength of the shock required to assess the risk of unexpected utilisation or partial withdrawal rates, because the level lapse stresses are not designed to reflect risks associated with utilisation and partial withdrawals. The application of homogenous risk groups within the mass lapse stress is too onerous. It is unreasonable to assume that all policyholders can assess the money-ness of their individual contracts (using a valuation basis such as ICS) from the insurers' perspective, and always act in ways that are most onerous to the insurer, rather than considering their own needs and circumstances.
Dai-ichi Life Holdings, Inc.	Japan	No	Yes	The stress level should be determined for each jurisdiction based on data submitted by volunteer groups. Although we submitted data, the calibration result is too high compared to our internal model.

				Our company is large in size compared to ordinary insurance companies, and our business focuses mainly on protection. We believe that the fact that risk diversification is more effective due to Low of Large Numbers is not reflected in the current ICS proposal, but we have not been able to propose specific improvement plan to IAIS because the method of calibration by IAIS is not shared. The calibration method should be disclosed and constructive discussions should be promoted. For non-life risks, method that reflects the risk profile of each IAIG is now being studeid (Paragraphs 309 and later of Public Consultation). Even for life risks, in particular for lapse risks, risk profiles are different due to differences in business model and product characteristics in each jurisdiction. Therefore, it is necessary to focus particularly on the stress level of each jurisdiction.
General Insurance Association of Japan	Japan	No	Yes	It is not relevant to consider that policyholder action could take place based on information that the policyholder does not know, such as the current estimate and surrender value of a policy. Therefore, it is not relevant to use the positive and negative surrender strain (comparison of current estimate and surrender value) to determine the surrender strain. Also, a rise in the surrender rate is unlikely for protection products. The surrender strain should take into account the characteristics of the policy (protection or savings products). If the ICS continues to determine surrender based on positive and negative surrender strains, we recommend making the following two corrections: (1) The current method to measure the level and trend component prescribed in the Technical Specifications, which assume that the surrender rate will always change negatively for every homogenous risk group (HRG), is too conservative. Instead, we recommend aggregating the total decreased amount of net asset values for all HRGs in upward and downward shock scenarios with a correlation factor of zero. (2) The method of measuring mass lapse components, which apply zero floor for each HRG, assumes that only those HRGs whose surrender strain is positive will face a rise in surrender rate. However, such an assumption is not a realistic scenario under mass lapse risk calculation. For example, reputational erosion should result in increased surrender regardless of the HRG. Therefore, we propose calculating the mass lapse component based on the total of life, or according to different geographical segments other than HRGs.

				Lastly, policyholder action is related to market characteristics and geographical segments. These levels should be set based on the historical data of the respective markets. In the case of Japan, the current surrender rate is too high compared with past results.
The Life Insurance Association of Japan	Japan	No	Yes	• The LIAJ heard Japanese life insurers (Volunteer Groups) have submitted the additional data for calibration and the LIAJ would like the IAIS to set stress level by individual region basis based on the additional data submitted by the Volunteer Groups. The LIAJ believe the current level of the calibration is overly high compared to their internal models. • It is not clear what kind of scenario would lead to mass lapses, but it is assumed that the IAIS considers some scenarios such as credit uncertainty, reputational deterioration and run up of insurance companies due to the management crisis. In those situation, there will be certain lapses of insurance contracts including both negative value and positive value policies for the insurer. Therefore, it is appropriate to calculate the Lapse risk for negative policies same as for positive policies. • Also, there are certain restrictions of actual lapse actions such as that the policy rider cannot be maintained if the main contract is lapsed. In addition to homogeneous risk groups, it is appropriate to consider contractual constraints in this respect. • Insurers have not been able to make concrete proposals for the improvement due to the calibration methods in the IAIS is not shared with insurers. In order to raise shared awareness, the LIAJ urge the IAIS to share calibration method with stakeholders and pursue constructive discussions among stakeholders. • As for non-life insurance risk, the IAIA is considering a method for reflecting risk profile of individual IAIGs more appropriately (as defined in Paragraph 309 and after, of the Consultative Document). As for life insurance risk, on the other hand, particularly with regard to lapse risk, the LIAJ considers such a risk profile would differ depending on the differences in business models and product characteristics in each jurisdiction. Therefore, it is necessary to consider stress levels focusing deeply on each jurisdiction's risk profile. • In fact, each lapse scenario is different because it depends on characteristics of products,

				but the product characteristics are not taken into consideration in the mass lapse assumption in this consultation document. It is supposed that this leads the excessively high stress especially in the individual-protect-typed-product, because there are no considerations on the possibilities of lapse- suppressing-factors such as loss of protection, requirement of assessment for taking out new insurance policy, cost of transferring insurance policy and taxation.
Financial Supervisory Service (FSS) & Financial Services Commission (FSC)	Korea (Republic of)	No	No	
American Council of Life Insurers	Office of General Counsel	No	Yes	It is unreasonably onerous to assume a 30% lapse stress for all retail products, in particular for individual life insurance. The purchase of insurance is motivated by fulfilling a long-term insurance need and therefore tends to be less sensitive to changes in interest rates. A policyholder's decision to lapse would include more factors than the difference between market and credited rates. Other factors would include loss of insurance protection, new underwriting, new sales costs, and tax considerations. Collectively, these factors mean that the 30% lapse stress goes far beyond an appropriate level of calibration for the risk of lapse associated with individual life insurance. The mass lapse risk charge should be refined and take into account characteristics of the product, rather than levying a flat charge across all retail products.
Legal & General	UK	No	Yes	We believe that there should be some allowance for diversification between lapses on different types of product and across different territories. Lapses on different products will have very different causes and it is not realistic to assume (for example) a mass lapse on all protection and savings business at the same time. Also, lapses in different territories' insurance market may have different underlying drivers and even where drivers are similar the conditions at the time of valuation will not necessarily be the same (e.g. high unemployment in one territory may not imply high unemployment in other territories). The current treatment would appear to penalise companies with a broad spread of product exposures.

Association of British Insurers	United Kingdom	No	Yes	The current ICS specification appears to imply that the lapse risk charges need to cover all policyholder options. Policyholders may exercise different kinds of options based on product features including partial withdrawals. Therefore, there is a risk of expected changes to the rate at which policyholders exercise their option and the extent to which such withdrawals are taken at the optimal level. However, the current technical specification is not clear on the strength of the shock required to assess the risk of unexpected utilisation or partial withdrawal rates, because the level lapse stresses are not designed to reflect risks associated with utilisation and partial withdrawals. Given the complexity associated with the calibration of various policyholder options, IAIG specific factors should be considered for risks other than a vanilla lapse. The application of homogenous risk groups within the mass lapse stress is too onerous. It is unreasonable to assume that all policyholders can assess the money-ness of their individual contracts (using a valuation basis such as ICS) from the insurers' perspective, and always act in ways that are most onerous to the insurer, rather than considering their own needs and circumstances.
Prudential Financial, Inc.	United States of America	No	Yes	Prudential Financial believes the mass lapse risk charge is excessive relative to the notional 99.5% VaR concept and is significantly higher than any IAIG mass lapse event in U.S. or Japanese history. We recommend that the mass lapse charge be specified relative to the best estimate (e.g., as an additive stress) as opposed to an absolute lapse rate. Regional and product idiosyncrasies are reflected in best estimate assumptions, and the mass lapse charge should be sensitive to them. This approach is more reflective of the risk. Under an absolute approach, products with high base lapse rates will have a minimal mass lapse charge (if any) while products with low lapse rates are unduly penalized. A relative stress more appropriately measures the risk. We believe the lapse level and trend stress is reasonable.

MetLife, Inc	USA	No	Yes	Please see our comments in response to Q78 above. Our concern regarding inadequate diversification, in particular geographical diversification applies equally to equity, lapse, mortality, morbidity and operational risk.
Northwestern Mutual	USA	No	Yes	The intensity of an actual lapse will differ by product type; and to be accurate so should the ICS requirement. Over the last several decades, our life insurance lapse rate for participating whole life policies has never exceeded 6%. For annuities, the maximum has been 17%. The purchase of insurance meets a long-term insurance need and therefore tends to be less sensitive to changes in interest rates. A policyholder's decision to lapse would include more factors than the difference between market and credited rates. Other factors would include loss of insurance protection (that may not be replaceable), new underwriting (perhaps resulting in higher premium classifications), new sales costs, and tax considerations. When mass lapses occur, they typically involve capital market products like guaranteed investment contracts (GICs) or funding agreements and may involve the effect of poor investment decisions. The IAIS should consider varying mass lapse stresses by product type. From our perspective we would not expect to see the mass lapse stress for whole life insurance to exceed 10% and something higher for annuities.

End of Section 7.8