

A Joint Valuation of Premium Payment and Surrender Options in Participating Life Insurance Contracts

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Abstract

- Life insurance contracts typically embed, in addition to an interest rate guarantee and annual surplus participation,
 - ▶ a *paid-up option*, the right to stop payments during the contract term,
 - ▶ a *resumption option*, the right to resume payments, and,
 - ▶ a *surrender option*, the right to terminate the contract early.
- Terminal guarantees on benefits payable upon death, survival and surrender are adapted after option exercise.
- Model framework and algorithm to *jointly* value the options is developed.
- Standard principles of risk-neutral evaluation are applied; the policyholder is assumed to use an economically rational exercise strategy.
- Option value sensitivity on different contract parameters, benefit adaptation mechanisms, and exercise behavior is analyzed numerically.

Adequate risk management needed for correct valuation of options and compliance with regulation rules

- Financial crisis and variable annuity products with embedded options have highlighted the importance of the valuation and the risk management of options.
→ *E.g. Equitable Life (2000), The Hartford (2009), AXA (2009).*
- Current and planned regulation rules prescribe risk-adequate capital deposits for embedded options.
→ *E.g. Solvency II, SST, NAIC RBC, and IFRS.*
- Hypotheses on the policyholder's exercise behavior are required to evaluate option values, in particular with regard to stress-testing of products.
→ *How much more value can policyholders get by exercising differently than what has been observed?*

Competitive advantage for product design and pricing when knowing the "fair" price

- Separate inspection of embedded options with regard to pricing and risk management.
→ *Pricing flexibility through reconfiguration of the conversion mechanism of the guaranteed benefits after exercise of the option.*
- Product design and offering of products along the needs and willingness to pay of customers.
→ *Possibility of offering zero-valued options, not to be paid for by the client.*
- Adequate and "fair" pricing of embedded options since policy inception.
→ *Competitive advantage.*

What is the contribution of this work?

- Model framework and methodology closest to the following:
 - ▶ Gatzert and Schmeiser (2008): paid-up and resumption options with focus on the maximal risk.
 - ▶ Bacinello (2003b): surrender option pricing.
 - ▶ Andersen (1999): option valuation algorithm for one option.
- Key features:
 - ▶ Several options are valued jointly.
→ *Most works consider options separately.*
 - ▶ Pricing through assumptions on policyholder's behavior is given.
→ *Not only assessment of maximal risk potential.*
 - ▶ Exercise through economically rational optimal strategy.
→ *Feasible strategy.*
 - ▶ Analysis of option values for various benefit conversion mechanisms in a policy assets perspective.
→ *Perspective allows for asset transparency in comparison with reserve-linked modeling.*

Structure of this talk

- **Introduction of the model framework**

- ▶ Basic contract \mathcal{B} including interest guarantee and surplus participation.
- ▶ Contract \mathcal{P} with a paid-up option $\mathcal{O}^{\mathcal{P}}$.
- ▶ Contract \mathcal{R} with a combined paid-up and resumption option $\mathcal{O}^{\mathcal{R}}$.
- ▶ Contract \mathcal{S} featuring a surrender option $\mathcal{O}^{\mathcal{S}}$.
- ▶ Contract \mathcal{Q} with a combined paid-up and surrender option $\mathcal{O}^{\mathcal{Q}}$.

- **Option valuation techniques and exercise behavior hypotheses**

- ▶ Maximum over all times of exercise of the option payoff.
- ▶ *Option value* reached using an optimal admissible exercise strategy.
- ▶ Upper bound of the option payoff for any exercise strategy (risk).

- **Numerical results and discussion**

- ▶ Option values for different contracts and parameters.
- ▶ Sensitivity analysis of the model.
- ▶ Comparison with Gatzert and Schmeiser (2008) and Bacinello (2003b).

Basic contract \mathcal{B}

- Life insurance contract with periodic premium payments featuring
 - ▶ an interest rate guarantee g , and,
 - ▶ an annual surplus participation, i.e. fraction α of the surplus.
- **Premium payments** B_{t-1} , $t = 1, \dots, T$, are paid annually at the beginning of the t th policy year given the insured remains alive.
 → *Annual premium payments $B_t \equiv B$ are supposed constant.*
- **Mortality statistics:** financial risk and mortality risk are uncorrelated; mortality risk is eliminated by writing a sufficiently large number of contracts (actuarial practice).
 → *Mortality risk is assumed not to contain systematic risk.*
- **Survival and death probabilities:**
 - ▶ ${}_t p_x$: x -year-old policyholder survives for the next t years.
 - ▶ ${}_t q_x = 1 - {}_t p_x$: x -year-old dies within the next t years.
 - ▶ q_{x+t} (resp. p_{x+t}): $(x + t)$ -year-old policyholder will die within the next year, between t and $t + 1$ (resp. survive one more year, the t th year).
- Guarantees are on benefits payable upon *death* and *survival*.
 → *Contract \mathcal{B} non-surrenderable and without paid-up option.*

Death benefit

- In case of death during the t th year of the contract, the assigned policyholder's beneficiary receives $\Upsilon_t^{\mathcal{B}} \equiv \Upsilon^{\mathcal{B}}$ at the end of the year.
- Actuarial equivalence principle: the expected value of the payments to the insured equals the expected premium payments from the insured:

$$B \sum_{t=0}^{T-1} {}_t p_x (1+g)^{-t} = \Upsilon^{\mathcal{B}} \left(\sum_{t=0}^{T-1} {}_t p_x q_{x+t} (1+g)^{-(t+1)} + {}_T p_x (1+g)^{-T} \right).$$

- The death benefit is given by

$$\Upsilon^{\mathcal{B}} = \frac{B \sum_{t=0}^{T-1} {}_t p_x (1+g)^{-t}}{\sum_{t=0}^{T-1} {}_t p_x q_{x+t} (1+g)^{-(t+1)} + {}_T p_x (1+g)^{-T}}.$$

Survival benefit I

- In case of survival until maturity T , the insurer pays out the accumulated policy assets A_T^B .
→ *Including guaranteed interest and surplus participation.*
- Annual premium payments B are split into
 - ▶ Premium B_{t-1}^R for term life insurance, used to buy insurance to cover the difference between the guaranteed death benefit Υ^B and the available policy assets A_{t-1}^B . For the t th year, fair pricing implies that

$$B_{t-1}^R = q_{x+t-1} \max(\Upsilon^B - A_{t-1}^B, 0).$$

- ▶ Savings premium $B_{t-1}^A = B - B_{t-1}^R$.
→ *Credited to the policy assets at the beginning of the t th year.*
- A_{t-1}^B and B_{t-1}^A annually earn the greater of the the guaranteed interest rate g or a fraction α of the annual surplus $(S_t/S_{t-1} - 1)$.

Contract payoff I

- Payoff $P_T^{\mathcal{B}}$ at maturity T is determined by the payments to the insured less the premium payments, compounded with the risk-free rate r :

$$P_T^{\mathcal{B}} = \sum_{t=0}^{T-1} \Upsilon_t^{\mathcal{B}} p_x q_{x+t} e^{r(T-t-1)} + {}_T p_x A_T^{\mathcal{B}} - \sum_{t=0}^{T-1} B_t p_x e^{r(T-t)}.$$

- Let $\Pi_0^{\mathcal{B}}$ denote the net present value of the contract payoff $P_T^{\mathcal{B}}$ at time $t = 0$. With E_t^Q denoting the conditional expected value with respect to the probability measure Q under the information available in t , one gets

$$\Pi_0^{\mathcal{B}} = E_0^Q \left(e^{-rT} P_T^{\mathcal{B}} \right).$$

Contract \mathcal{P} with paid-up option and death benefit

- Contract \mathcal{P} based on basic contract \mathcal{B} .
- Paid-up option $\mathcal{O}^{\mathcal{P}}$: policyholder has the right to exercise $\mathcal{O}^{\mathcal{P}}$ (once) annually until maturity. $\rightarrow \mathcal{O}^{\mathcal{P}}$ is a *Bermudan-style option*.
- After exercising $\mathcal{O}^{\mathcal{P}}$ at time $t = \tau$, $\tau = 1, \dots, T - 1$, denoted by $\mathcal{O}^{\mathcal{P}(\tau)}$, and given the policyholder is still alive, the terminal benefits are adjusted according to a mechanism described below.
- **Adjusted death benefit** calculated by taking the accumulated policy assets $A_{\tau}^{\mathcal{B}}$ as single premium for a new contract,

$$\gamma^{\mathcal{P}(\tau)} = \frac{A_{\tau}^{\mathcal{B}}(1 + \gamma_{\tau}^{\mathcal{P}})}{\sum_{t=\tau}^{T-1} {}_{t-\tau}p_{x+\tau} q_{x+t} (1 + g)^{-(t-\tau+1)} + {}_{T-\tau}p_{x+\tau} (1 + g)^{-(T-\tau)}},$$

with $\gamma_{\tau}^{\mathcal{P}}$ a model parameter, with default value 0.

\rightarrow *Parameter represents flexibility to adapt benefits.*

Contract \mathcal{R} with paid-up and resumption options I

- Contract \mathcal{R} based on contract \mathcal{P} with paid-up option.
- Combined paid-up and resumption option $\mathcal{O}^{\mathcal{R}}$: right to stop premium payments at time $\tau = 1, \dots, T - 1$, and to resume payments at time $\nu = \tau + 1, \dots, T - 1$.
 → $\mathcal{O}^{\mathcal{R}(\tau, \nu)}$ denotes the combined exercise at times τ and ν .
- **Death benefit**

$$\gamma^{\mathcal{R}(\tau, \nu)} = \frac{A_{\nu}^{\mathcal{P}(\tau)}(1 + \gamma_{\nu}^{\mathcal{R}}) + B \sum_{t=\nu}^{T-1} {}_{t-\nu}p_{x+\nu} (1 + g)^{-(t-\nu)}}{\sum_{t=\nu}^{T-1} {}_{t-\nu}p_{x+\nu} q_{x+t} (1 + g)^{-(t-\nu+1)} + {}_{T-\nu}p_{x+\nu} (1 + g)^{-(T-\nu)}},$$

with $\gamma_{\nu}^{\mathcal{R}}$ a model parameter, with default value 0.

Contract \mathcal{R} with paid-up and resumption options II

- **Survival benefit** given by $A_T^{\mathcal{R}(\tau,\nu)}$, with $A_t^{\mathcal{R}(\tau,\nu)}$, $t = \nu + 1, \dots, T$:

$$A_t^{\mathcal{R}(\tau,\nu)} = \left(A_{t-1}^{\mathcal{R}(\tau,\nu)} + {}_{t-1}p_x \left[B - q_{x+t-1} \max(\Upsilon^{\mathcal{R}(\tau,\nu)} - A_{t-1}^{\mathcal{R}(\tau,\nu)}, 0) \right] \right) \cdot (1 + \max[g, \alpha(S_t/S_{t-1} - 1)]),$$

with $A_\nu^{\mathcal{R}(\tau,\nu)} = A_\nu^{\mathcal{P}(\tau)}(1 + \gamma_\nu^{\mathcal{R}})$.

- **Contract payoff** at maturity T :

$$\begin{aligned} P_T^{\mathcal{R}(\tau,\nu)} &= \sum_{t=0}^{\tau-1} \Upsilon^{\mathcal{B}} {}_t p_x q_{x+t} e^{r(T-t-1)} + \sum_{t=\tau}^{\nu-1} \Upsilon^{\mathcal{P}(\tau)} {}_t p_x q_{x+t} e^{r(T-t-1)} \\ &\quad + \sum_{t=\nu}^{T-1} \Upsilon^{\mathcal{R}(\tau,\nu)} {}_t p_x q_{x+t} e^{r(T-t-1)} + {}_T p_x A_T^{\mathcal{R}(\tau,\nu)} \\ &\quad - \sum_{t=0}^{\tau-1} B {}_t p_x e^{r(T-t)} - \sum_{t=\nu}^{T-1} B {}_t p_x e^{r(T-t)}. \end{aligned}$$

Option valuation

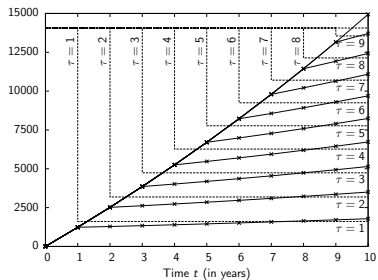
- Valuation of options is connected to the policyholder's exercise behavior.
- Different ways to approach the valuation of the embedded options, e.g.,
 - ▶ the maximum over all possible times of exercise of the expected value of the option payoff,
 - ▶ the *option value* that can be reached using an optimal admissible exercise strategy,
 - ▶ the upper bound of the option payoff for any exercise strategy.
- 1st and 3rd approaches suppose the policyholder to know the future for choosing the optimal time of exercise.
→ *This is not, in practice, a feasible strategy.*
- 3rd approach assesses the maximal risk potential on a possible path, see, e.g., Kling et al. (2006), Gatzert and Schmeiser (2008).
→ *Can be helpful for stress-testing of products.*

Optimal admissible exercise strategy

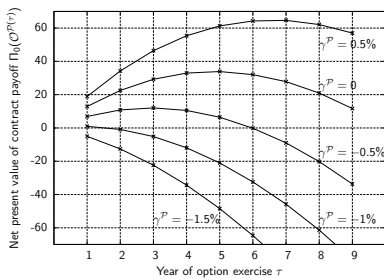
- Option valuation through considering a policyholder who follows an exercise strategy that maximizes the option value given the information available at the exercise date(s).
- Approach leads to an optimal stopping problem that can be solved using, for example, Monte Carlo simulation methods, as is done, e.g., in Andersen (1999), Douady (2002) or Kling et al. (2006).
- Whenever the underlying model for the economy has only one source of risk, an optimal admissible strategy for exercising Bermudan-style options can be found by looking only at the exercise value of the option, see Douady (2002).
→ *This is apparently equivalent to considering only the current value of the accumulated policy assets in the present framework.*
- Extension of Kling et al. (2006) in a setting of a contract with two options.

Numerical simulation

- Monte Carlo simulation with antithetic variables and $N = 1\,000\,000$ different paths. → *Variance reduction by generating negatively correlated variables such that large and small outputs are counterbalanced (see, e.g., Hull (2009, p. 433)).*
- Average population mortality data derived from the Bell and Miller (2002) cohort life tables for the United States.
- Reference example with the following parametrization:
 - ▶ $x = 30$ and $x = 50$ year-old policyholders in 2010 at contract inception,
 - ▶ contract with time to maturity $T = 10$,
 - ▶ yearly premium payments $B = 1\,200$ (currency units),
 - ▶ risk-free interest rate $r = 4\%$,
 - ▶ guaranteed interest rate $g = 3\%$, and,
 - ▶ insurer's investment portfolio with volatility $\sigma = 0.20$.
- First step: calibrate the fraction α of the annual investment returns to get fair contract conditions.
→ *Standard bisection method is used to determine α for given g .*

Policy assets $A_t^{\mathcal{P}(\tau)}$, death benefit $Y^{\mathcal{P}(\tau)}$, and $\Pi_0(\mathcal{O}^{\mathcal{P}(\tau)})$ 

(a) Assets $A_t^{\mathcal{B}}$, $A_t^{\mathcal{P}(\tau)}$ (solid lines), and death benefit $Y^{\mathcal{B}}$, $Y^{\mathcal{P}(\tau)}$ (dashed lines) in contract \mathcal{P} for different $\tau = 1, \dots, 9$.



(b) Sensitivity analysis of $\Pi_0(\mathcal{O}^{\mathcal{P}(\tau)})$ for different $\gamma_{\tau}^{\mathcal{P}} = \gamma^{\mathcal{P}} = -1.5\%, \dots, 0.5\%$.

Figure: Analysis of contract \mathcal{P} with paid-up option.

→ Parameters: $T = 10$, $B = 1200$, $r = 4\%$, $\sigma = 0.20$, $g = 3\%$, $x = 30$.

→ $\gamma^{\mathcal{P}} = -1\%$ quasi annihilates the payoff for all exercise times.

Option valuation for different contract parametrizations

x	T	σ	g	r	α	$\Pi_0^K(\mathcal{O}^{\mathcal{P}})$	Value / PVP
30	10	0.20	3%	4%	24.1%	33.5 (0.2)	0.6%
50	10	0.20	3%	4%	29.3%	139.7 (0.4)	2.6%
30	20	0.20	3%	4%	42.8%	137.6 (1.1)	1.5%
30	10	0.10	3%	4%	42.4%	33.5 (0.3)	0.6%
30	10	0.20	1%	4%	36.1%	32.1 (0.6)	0.6%
30	10	0.20	1%	2%	32.4%	37.7 (0.2)	0.7%

Table: Illustration of the option value, standard error and ratio of the option value to the expected premium payments for the contract \mathcal{P} , with respect to different values of the age of the policyholder x , the contract duration T , the volatility of the investment portfolio σ , the guaranteed interest rate g , the risk-free interest rate r , and the determined participation rate α for the underlying contract \mathcal{B} to be fair. Annual premium payments are $B = 1\,200$.

→ x and T have a high importance for the option value.

→ Variations of σ , g , and r are counter-balanced by α .

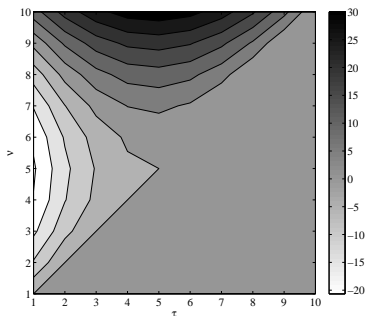
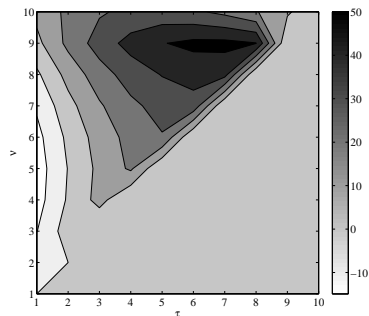
Option payoff $\Pi_0(\mathcal{O}^{\mathcal{R}(\tau, \nu)})$ as a function of τ and ν (a) $\Pi_0(\mathcal{O}^{\mathcal{R}(\tau, \nu)})$ with $\gamma_\nu^{\mathcal{R}} = 0.0\%$.(b) $\Pi_0(\mathcal{O}^{\mathcal{R}(\tau, \nu)})$ with $\gamma_\nu^{\mathcal{R}} = 0.5\%$.

Figure: $\Pi_0(\mathcal{O}^{\mathcal{R}(\tau, \nu)})$ and sensitivity with $\gamma_\nu^{\mathcal{R}}$ as a function of τ and ν .

- Triangle $\nu \leq \tau$ is zero as resumption cannot be before paid-up.
- Boundaries $\tau = T$, $\nu = T$ correspond to no-exercise situations.
- Times and value of maximum payoff change with $\gamma_\nu^{\mathcal{R}}$.

Option valuation in contract \mathcal{R}

Contract duration	Item	Valuation with $\Pi_0(\mathcal{O}^{\mathcal{R}}(\tau^*, \nu^*))$	Valuation with $\Pi_0^{K,L}(\mathcal{O}^{\mathcal{R}})$	Valuation with $\Pi_0^{\max}(\mathcal{O}^{\mathcal{R}})$
$T = 10$	Value	33.5 (0.2)	33.5 (0.2)	198.1 (0.2)
	Time of 1st exercise	5	5.0 (0.0)	3.9 (0.0)
	Times of 2nd exercise	10	10.0 (0.0)	9.6 (0.0)
	PVP	5 535	5 538 (0.0)	4 493 (3.1)
	Value / PVP	0.6%	0.6%	4.4%

Table: Option valuation in contract \mathcal{R} .

Reported results are for a fair underlying contract \mathcal{B} , $x = 30$, $r = 4\%$, $g = 3\%$ and $\sigma = 0.20$.

→ Maximal values when $\nu = T = 10$, i.e. second option is best never exercised ($\gamma_{\nu}^{\mathcal{R}} = 0.0\%$).

→ Same values as with paid-up option only: $\Pi_0^{K,L}(\mathcal{O}^{\mathcal{R}}) = \Pi_0^K(\mathcal{O}^{\mathcal{P}})$, i.e. resumption option value is zero.

→ Swiss life insurance contract: $\Pi_0^{K,L}(\mathcal{O}^{\mathcal{R}})|_{\nu=\min(\tau+2,T)} = 20.7 (0.3)$ with $\tau = 8.0$, $\nu = 10.0$. PVP is 8 386 and ratio option value / PVP is 0.3%.

Option valuation in contract \mathcal{Q}

Contract duration	Item	Valuation with $\Pi_0(\mathcal{O}^{\mathcal{Q}}(\tau^*, \theta^*))$	Valuation with $\Pi_0^{K,L}(\mathcal{O}^{\mathcal{Q}})$	Valuation with $\Pi_0^{\max}(\mathcal{O}^{\mathcal{Q}})$
$T = 10$	Value	33.5 (0.2)	33.5 (0.2)	283.1 (0.2)
	Time of 1st exercise	5	5.0 (0.0)	4.7 (0.0)
	Times of 2nd exercise	10	10.0 (0.0)	5.7 (0.0)
	PVP	5 535	5 538 (0.0)	4 998 (2.9)
	Value / PVP	0.6%	0.6%	5.7%

Table: Option valuation in contract \mathcal{Q} .

Reported results are for a fair underlying contract \mathcal{B} , $x = 30$, $r = 4\%$, $g = 3\%$ and $\sigma = 0.20$.

→ $\Pi_0^{K,L}(\mathcal{O}^{\mathcal{Q}}) = \Pi_0^K(\mathcal{O}^{\mathcal{P}})$, hence the surrender option value is again zero.

→ \mathcal{R} and \mathcal{Q} are very similar since the additional option offered is zero-valued (with $\gamma_{\tau}^{\mathcal{R}} = \gamma_{\theta}^{\mathcal{Q}} = 0$).

→ Joint valuation is in general not equal to the sum of the single options:

- Contract \mathcal{P} with $\gamma^{\mathcal{P}} = 0.0\%$: $\Pi_0^K(\mathcal{O}^{\mathcal{P}}) = 33.5$
- Contract \mathcal{S} with $\gamma^{\mathcal{S}} = 0.5\%$: $\Pi_0^K(\mathcal{O}^{\mathcal{S}}) = 45.5$
- Contract \mathcal{Q} with $\gamma^{\mathcal{Q}} = 0.5\%$: $\Pi_0^{K,L}(\mathcal{O}^{\mathcal{Q}}) = 56.0$

Conclusion

- Model framework dealing with fair and joint valuation of embedded options; implementation of a robust numerical algorithm.
- Drivers of the option values pointed out:
 - ▶ Conversion mechanism of the guaranteed benefits.
→ *Throughout the studied situations, paid-up option values are of the order of 1 – 3% of the expected premium payments.*
 - ▶ Exercise behavior of the policyholder.
→ *Even though an optimal exercise behavior may not be the empirically relevant case, nor the upper bound for the inherited risk be reached in practice, the practical relevance of adequate pricing is shown to be important.*
- Substantial value of embedded options shows the necessity of appropriate pricing and adequate risk management.
→ *Values of embedded options should be detailed carefully in particular with regard to the offered benefits and under various hypotheses of the client's exercise behavior.*

Further information

- **Reference for this publication**

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