CORE MATTERS

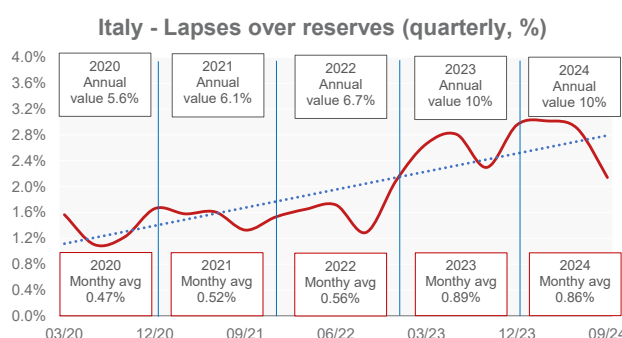## Surrender risk in life insurance: drivers & trends.

Empirical evidence from the Italian market

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July 24th, 2025

Our Core Matters series provides thematic research on macro, investment, and insurance topics

- Life insurance contracts allow policyholders to withdraw before maturity (surrenders). Lapses occur when premiums are not paid within the grace period.

- **Liquidity needs, opportunity-cost**, and changes in coverage needs over time are the primary drivers of surrenders.

- The latter increased in 2022-23, largely because of rising interest rates (particularly in ITA and FRA) where alternative financial products (gov. bonds) became more attractive.

- Surrenders pose **risks** such as **loss of future premiums**, **liquidation costs**, reduced **solvency ratios**, and complications in **actuarial planning**.

Italy - Lapses over reserves (quarterly, %)

| 2020 Annual value 5.6% | 2021 Annual value 6.1% | 2022 Annual value 6.7% | 2023 Annual value 10% | 2024 Annual value 10% |

| 2020 Monthy avg 0.47% | 2021 Monthy avg 0.52% | 2022 Monthy avg 0.56% | 2023 Monthy avg 0.89% | 2024 Monthy avg 0.86% |

Source: Ania, GenAM Research

- Analysis of data from the **Italian market** – over 150 companies – shows that i**nterest rates dynamics, household liquidity**, and **distribution channels significantly influence surrender rates**.

- For **traditional policies**, the **positive elasticity** of surrenders to **BTP yields** and **mortgage interest rates**, highlights the sensitivity of policyholders to economic conditions. There is also a strong inverse relation between households' liquidity and surrender rates.

- **Unit-Linked Policies**: there, too, the inverse relationship between surrenders and household liquidity is confirmed. But **higher BTP yields tend to reduce surrenders to avoid the crystallisation of capital losses**.

- Looking ahead, our proprietary forecast model predicts a **6% CAGR growth in surrenders over the next three years**. The surrenders on reserves ratio is projected to decrease, all else equal, towards its trend, after the 2022 spike.

- To mitigate the surrender risk, companies sometimes use legal tools, such as **lock-in clauses** or **penalties** for early surrender. The presence of **minimum return guarantees and the possible** loss of tax benefits may help, too.

- From a strategic perspective, focusing on **efficient liquidity management**, innovative **product development**, and effective **customer retention strategies –** including education and more frequent advice service during spikes in market volatility **–** may contribute to **mitigate the impact of surrenders** and allow companies to keep thriving in a dynamic/volatile market environment.

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CONTENT

In this work we analyse surrenders in the life insurance business: after a brief definition of the term and its main differences with "lapsing", we analyse the root causes of the phenomenon and its recent dynamics in Italy and France (Section 1). In section 2 we gauge the impacts on life insurance companies and the contractual features used in different European countries to minimise the surrender risk. In Section 3 we provide empirical evidence from the Italian market, one of the most exposed to *early termination* among European countries. Through a panel model, we estimate the elasticity of surrenders to different factors related to the main causes elicited in section 1. Section 4 concludes by providing our forecast of surrenders for the next three years.

1. Surrenders: definition, causes, trends

The term **Surrender** identifies a clause in investment life insurance policies that allows the policyholder to **withdraw from the contract before the scheduled maturity** and receive the invested capital back. In life insurance – from whole life to Individual Pension Plan – policies that combine coverage and financial investment usually include this clause. The conditions can vary depending on the type of contract: some only allow for a total surrender, meaning the entire invested capital is withdrawn, resulting in the cancellation of the policy; others also offer the possibility of a partial surrender, which keeps the policy active.

Lapsation, instead, refers to policyholders failing to pay the premium within the grace period stipulated by the insurance contract. Therefore, the insurance cover is suspended. Of course, if policyholders can meet their obligations during the grace period, the coverage is usually reinstated. A life policy
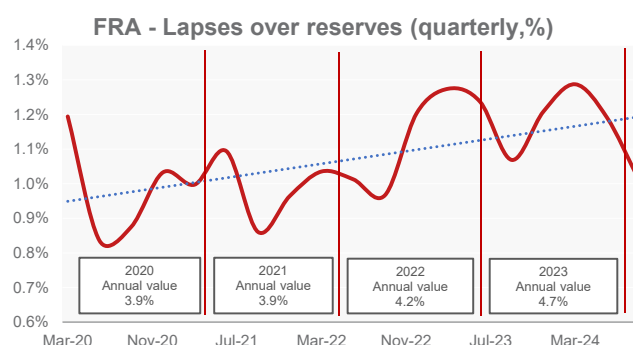
accruing benefits (whole life, annuities) can for some time feed on the reserves accrued. On the contrary, the benefits of term life, which offers pure risk coverage, are suspended in the wake of premiums due.

Surrenders on life insurance policies are a **physiological phenomenon on the insurance market**, and they are influenced by a combination of personal, financial, and contractual factors. Academic and professional literature recognises two[1] main motivations pushing policyholders towards early termination of a life contract:

1. **Liquidity Needs**: policyholder may surrender the life insurance contract when facing personal economic or financial difficulties, such as unemployment or health issues.

2. **Opportunity-cost**: the decision of early termination is linked to changes in the value of the life contract relative to broader financial market conditions, e.g. as interest rates move. Typically, an increase in interest rates may push savers to divert their money towards higher-yielding financial alternatives or towards new, higher-yielding life insurance products, or to reduce their existing or future debt exposure (loans, mortgage, etc.).

In the past few years, **surrenders have increased**, boosted by the increase of interest rates in 2022, which enhanced the competitiveness of other financial vehicles. In **France**, in 2022, a traditional life insurance was granting policyholders around 1.8-2% yield on average. As rates went up, the product quickly lost ground in favour of **Livret A**, a deposit accounts with a net public guarantee of minimum return. The latter was promptly adjusted by the French Government in 2022, to 3% from 1% before.

FRA - Lapses over reserves (quarterly,%)

| | 2020 Annual value 3.9% | 2021 Annual value 3.9% | 2022 Annual value 4.2% | 2023 Annual value 4.7% |

Source: FA, GenAM Research

In the same period, the Italian Government started to push **BTPs towards retail investors**, leveraging on increasing yields and low taxation (12.5%), compared to other low risk

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[1] A third reason to lapse evidenced by literature is linked to changes in coverage needs over time. For example, if children grow up and become financially independent, the policyholder might no longer feel the need to maintain a life insurance policy.

financial instruments, included life policies. As a result, investors moved part of their stock and new flows of savings away from life insurance. This trend was favoured by **banks** and **financial advisors**, who **diverted** their **clients from life insurance towards low fee, administered savings vehicles, as a client-retention strategy**.

2. Impact on Life Insurance Companies and Mitigation Strategies

Surrenders (as well as lapses) pose significant risks to life insurance companies:

- **Loss of Future Premiums**: Negative effect on cash flows and long-term profitability.
- **Liquidation Costs**: Pressure on liquidity reserves, potentially forcing suboptimal asset sales.
- **Solvency Ratio**: Lapses can reduce the company's ability to meet financial obligations.
- **Actuarial Planning**: Unexpected lapses complicate future liability predictions and risk management.

These combined factors make lapses & surrenders critical risks that life insurance companies must manage carefully. Generally, to reduce the exposure, contractual restrictions on life insurance surrenders are introduced to discourage premature policy interruption/termination and to ensure the

Italy - Lapses over reserves (quarterly, %)

Source: Ania, GenAM Research

financial stability of insurance companies. Key strategies to mitigate the risk include:

- **Lock-in clauses**: Specific clauses limiting surrender possibilities before a pre-defined maturity threshold is reached.
- **Minimum Return Guaranteed**: Higher minimum returns discourage lapsation.
- **Penalties** for Early Surrender, reducing the amount received by the policyholder, constitute a barrier to premature policy termination.

- **Taxation**: Loss of tax benefits associated with lapsation.
- **Market Value Adjustment**: a contractual feature that links the value of surrender penalties to the evolution of specific financial indices.

In Europe, such barriers on life insurance surrenders vary from country to country (see next chart). In Italy and France, they are relatively low. Usually, contracts may include 1-2 years **lock-in clauses** or (light) penalties, especially in the first years of the contract. In **Germany**, life insurance policies may include penalties for early termination, but these tend to decrease over time.

In other European countries like the **UK, Spain** and the **Netherlands**, the presence of withdrawal penalties, tax barriers on exit and penalisation linked to the market Value Adjustment, contribute to contain surrenders, together with the generosity of an average minimum guarantee return.

> *In Europe, Italy and France seem to be most exposed to surrender risk.*

3. Empirical Evidence from Italy

Using data from [Infobila](#) on **150+ companies operating in**

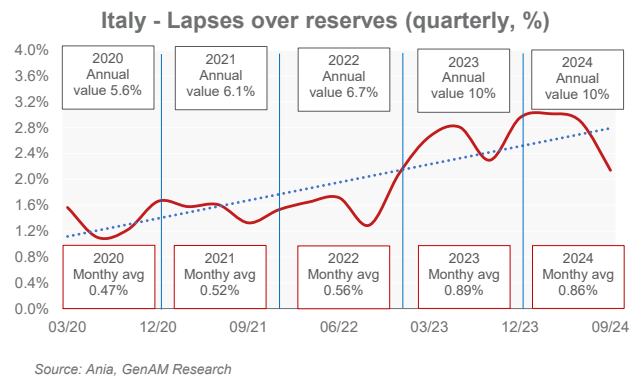Surrender risk exposure and barriers on early termination

	Italy	France	Germany	Belgium	Spain	Netherlands
Exposed Reserves % of Life Tot.	72%	72%	NA	79%	NA	Mostly run-off
Avg. Min. Guarantees	1%	0%	3%	2%	3%	4%
Withdrawal penalties or limits	Low	Low	Yes	Yes	Yes	Yes
Tax barriers on exit	Low	Yes*	Yes	Yes	NA	Yes
Market Value Adjustment	No	No	Yes	Yes	No	Yes

Source: GenAM Research, Fitch

Italy from 2000 to 2023, we empirically test the causes of early termination. We augmented the dataset with macroeconomic variables (interest rates, unemployment rate, disposable income, etc.) and developed a proprietary **panel model** with cross-section weights **both for traditional policies** and **unit-linked** policies. For traditional policies, the model specification is:

$$\Delta \log(surrenders)_t$$
$$= \beta_0 + \beta_1 \Delta \log(surrenders)_{t-1} + \beta_2 \Delta \log(reserves)_{t-1}$$
$$+ \beta_3 \Delta \log(GWP)_{t-2} + \beta_4 \Delta \log(HH\ liquidity)_t$$
$$+ \beta_5 \Delta \log(BTP\ 10Y\ yield)_{t-1}$$
$$+ \beta_6 \Delta \log(Life\ insurance\ annual\ avg\ yield)_{t-1}$$
$$+ \beta_7 \Delta \log(House\ loan\ interest\ rate)_t + d_{Bank}$$

Where:

- **Surrender rate** at t-1 (log value): the logic, widely accepted in the academic literature, is that higher values of past surrenders reduce the overall present early-terminable universe.

- **Reserves** at t-1 (log value) are used to control for differences in company size.

- **Gross Written Premiums** (GWP) with a 2-period lag, to embed the average lock-in clause period.

- **Households' liquidity, directly associated with the probability to lapse and surrender[2].**

- **10-year BTP yield**, usually reflecting the opportunity-cost motive, as well as the average return registered by life insurance policies (at t-1).

- Average interest rate on **house mortgage rate**: this may be linked to both the liquidity need and the cost-opportunity motive.

- A dummy variable for the **distribution channel**, banking vs. agency, to control for client retention policies.

For **unit-linked policies** (UL), the **European stock market return (MSCI EU index) is added**, while the passive interest rate on mortgages is carved out (not statistically significant).

3.1 Results Interpretation

The results of the models are shown in the following tables. **Estimated coefficient** (Betas) should be interpreted in terms of **elasticity**: they represent the percentage variation of surrenders to a 1% variation of the explanatory variable.

In the **traditional life segment**, the results confirm that the **variation in redemptions is driven by two main factors (liquidity needs and opportunity cost).** Indeed, the annual change in surrender rate reacts with **positive elasticity** to unit percentage increases in the **remuneration of BTP** (0.29%) and the **passive interest rate applied to mortgages** (0.56%). **Households' liquidity** and the average yield obtained by life insurance policies are, as expected, **inversely correlated with surrender risk**.

Regarding the **unit-linked** insurance market, the inverse relationship between surrenders and household liquidity is confirmed. The yield on **10-year BTPs exerts an opposite reaction to the one observed in the case of traditional policies**: as the yield on BTPs increases, the surrenders of unit-linked policies decrease. This difference in behaviour

reflects the **different nature of traditional products and unit-linked policies**. Since the profile of the latter is more akin to financial products (the financial risk is borne by the

Surrenders: elasticity in traditional life insurance.

Variable	Coefficient	Std. Error	t-Statistic	Prob.	Stat. Significance
C	0.037	0.036	1.010	0.316	
D_BANK	0.038	0.023	1.637	0.106	*
House loan interest rate	0.556	0.135	4.113	0.000	***
10Y BTP yield (log)	0.289	0.046	6.239	0.000	***
Reserves (t-1, log)	-0.837	0.175	-4.792	0.000	***
Surrenders (t-1, log)	-0.391	0.027	-14.599	0.000	***
Life insurance policies avg yield	-3.638	0.405	-8.980	0.000	***
Gross Written Premiums (t-2, log)	0.405	0.079	5.133	0.000	***
Household liquidity (log)	-8.861	1.087	-8.152	0.000	***
Weighted Statistics					
R-squared	0.465		Mean dependent var		0.148
Adjusted R-squared	0.458		S.D. dependent var		1.379
S.E. of regression	1.015		Sum squared resid		677.056
F-statistic	71.289		Durbin-Watson stat		2.360
Prob(F-statistic)	0.000				
Unweighted Statistics					
R-squared	0.437		Mean dependent var		0.131
Sum squared resid	707.945		Durbin-Watson stat		1.518

policyholders), it is reasonable to expect that the component related to opportunity cost is predominant. An increase in the BTP yield would, in fact, lead to a devaluation of the underlying value of the policy and a consequent disincentive to surrender the position to avoid realizing a loss[3]. Following the same logic, surrenders slow when the performance of the stock index (MSCI Europe) deteriorates.

Surrenders: elasticity in unit-linked life insurance

Variable	Coefficient	Std. Error	t-Statistic	Prob.	Stat. Significance
C	0.445	0.021	21.106	0.000	***
10Y BTP yield (log)	-0.191	0.046	-4.183	0.000	***
Surrenders (t-1, log)	-0.202	0.027	-7.438	0.000	***
Reserves (t-1, log)	1.048	0.099	10.574	0.000	***
MSCI Index	-0.163	0.047	-3.440	0.001	***
Household liquidity (log)	-17.735	0.762	-23.265	0.000	***
Gross Written Premiums (t-2, log)	0.047	0.027	1.739	0.086	**
Weighted Statistics					
R-squared	0.754		Mean dependent var		0.204
Adjusted R-squared	0.752		S.D. dependent var		3.964
S.E. of regression	1.407		Sum squared resid		1347.584
F-statistic	348.347		Durbin-Watson stat		2.430
Prob(F-statistic)	0.000				
Unweighted Statistics					
R-squared	0.379		Mean dependent var		0.094
Sum squared resid	1448.603		Durbin-Watson stat		1.790

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[2] Another variable directly associated to liquidity needs is the Unemployment rate. It results statistically non-significant, though,

probably because the effect is already captured by the households' liquidity variable.

[3] Unless fear prevails and savers sell anyway to avoid further losses.

4. Lapse forecast model: +6% CAGR over the next 3Y. Back to norm

We then build a second **proprietary model to forecast surrenders for the Italian market**. It is a time-series model that regresses surrenders annual growth rate on:

- **GWP** with a 2-year lag, to embed the average holding period.
- **Surrenders** at t-1.
- **The 10-year BTP yield**.
- A dummy variable, to consider a sudden increase in surrenders experienced in 2021.

Variables related to liquidity needs are not statistically significant in this case. According to the model, in our base scenario[4], surrenders should grow by 6% CAGR in the next 3 years, driven by GWP growth and BTP dynamics.
GWP was +20% in 2024 and should continue growing in 2025 and in 2026, albeit at a slower pace (mid-single-digit). BTP is expected to move from 4.26 in 2024 to 3.4 in 2025 to 3.6 in 2026, still attractive compared to life insurance yields, given also the lighter taxation.

Therefore, the ratio surrenders/reserves should converge towards its historical norm after the spike caused by the 2022 increase in interest rates. The surrender risk should therefore be manageable on average for the insurance players in the Italian market.

> *In terms of surrenders, interest rates affect traditional life and UL policies in opposite ways.*
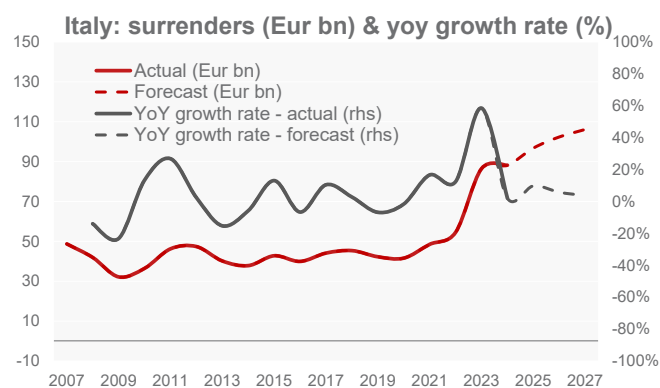
4.1 Implications for insurers

A better understanding of the drivers of surrenders, as well as of the projected 3-years future lapse dynamics, allows life insurance companies to **better plan their financial and market strategies**, liquidity buffers, improving **long-term stability** and **competitiveness**.

Concerning financial Planning, companies can more accurately predict future cash flows, allowing for more **efficient management of liquidity reserves**. Furthermore, they can also **better assess their investment strategies**, avoiding the need for asset sales under unfavourable conditions[5].

Surrender forecast model – output

Variable	Coefficient	Std. Error	t-Statistic	Prob.	Stat. Significance
C	0.160	0.031	5.191	0.001	***
Gross Written Premiums (t-2, log)	0.790	0.154	5.119	0.001	***
10Y BTP yield, (t-1)	0.142	0.028	5.100	0.001	***
Surrenders (t-1, log)	-0.490	0.159	-3.084	0.013	***
D21 (dummy variable)	-0.214	0.091	-2.345	0.044	***
Statistics					
R-squared	0.823		Mean dependent var		0.067
Adjusted R-squared	0.725		S.D. dependent var		0.152
S.E. of regression	0.080		Akaike info criterion		-1.937
Sum squared resid	0.057		Schwarz criterion		-1.653
Log likelihood	20.524		Hannan-Quinn criter.		-1.940

Italy: surrenders (Eur bn) & yoy growth rate (%)

- Actual (Eur bn)
- Forecast (Eur bn)
- YoY growth rate - actual (rhs)
- YoY growth rate - forecast (rhs)

Source: Ania, GenAM Research

On the market strategy side, other than the "traditional" barriers to surrenders cited before, companies may **focus on retention** and **communication strategies,** including **client education initiatives** and **more frequent advice service during spikes in market volatility, to reduce surrender risk**:

- **Retention strategies**: **loyalty programs** could help tackle the competition between insurers and other financial products, especially when surrenders are driven by the opportunity-cost motive. In particular, **personalised rewards** and **incentives** that align with the customers' individual needs and preferences are key to enhancing client engagement, fostering long-term relationships, reducing surrenders and ultimately contributing to stable business growth.

A second option lies in the offering of **flexible premium payment**: this could make it easier for policyholders to keep up with their payments, reducing the likelihood of surrender due to financial strain. A third option involves allowing clients to add extra savings to their life insurance policy, possibly at a discounted fee, during market drawdowns. This strategy would counteract the clients' urgency to surrender, which is likely to arise during market

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[4] Forecasts on 10Y BTP are from GenAM Macro & Market Research, while those on Life insurance gross written premiums are from GenAM Insurance & AM Research.

[5] Or an undesired debt exposure increase, in case a company prefer to resort to loans instead of crystallising losses.

headwinds, while also leveraging higher benefits during financial market recovery phases.

As an alternative, **policy Loans** can be offered by life insurers, allowing clients to take out a loan using the life insurance policy accumulated value as collateral. This provides immediate liquidity without requiring policy surrender. Moreover, the insurance contract would remain in force, allowing clients to continue benefitting from insurance coverages like death and disability as well as the proceeds of the invested capital. While in Italy this kind of option, which was used in the past, seems to have lost appeal lately, in other European countries such as the UK and Germany, policy loans are a more common financial management tool for clients.

- **Communication & education strategies**: Multichannel, personalized customer interactions are essential for proactively engaging with customers who are at risk of lapsing. According to McKinsey, these interactions can reduce customer churn by up to 30%.

Providing clear information about the benefits and long-term value of the policy can help policyholders understand the importance of maintaining their coverage. Insurers should also make sure their clients know the alternative options to surrender and should encourage clients to seek assistance before cancelling their coverage. Especially for hybrid or unit-linked products, market drawdowns are likely triggers for surrenders, playing on policyholders' fear and discontent. Therefore, a skilled distribution workforce is key in assisting clients, re-establishing their long-term perspective through proper and informed communication. This timely approach should help to mitigate lapses when they hit both the insurers and the insured.

5. Conclusions

We explored the topic of surrenders in the life insurance business, providing a comprehensive analysis of its definitions, causes, and recent trends in Italy and France.

We examined the significant risks that surrenders pose to life insurance companies and the various strategies employed to mitigate these risks across European countries.

Our empirical analysis, using data from the Italian market, highlights the key factors influencing surrenders, including macroeconomic variables and company-specific characteristics. The results confirm the importance of both liquidity needs and opportunity-cost motives in driving surrenders.

Looking ahead, our proprietary forecast model predicts a **contained growth in surrenders at a 6% CAGR over the next three years**, down from the peak of 2023. This back-to-norm growth rate (long-term avg growth rate is 6.7%) will allow life insurance companies to better plan their financial and market strategies, enhancing long-term stability and competitiveness. By focusing on efficient liquidity management, and effective customer retention and communication strategies, the impact of surrenders can be mitigated, helping companies to thrive when the market environment becomes more challenging. Such measures include loyalty programs, policy loans, flexible payment options, and multichannel, personalized customer interactions.

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