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Lapse rate modeling: a rational expectation approach


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Notes

1. We need to further assume some smoothness and integrability conditions.
2. Specifying the condition at $r=0$ is a delicate issue. Zvan et al. ([1998](#)) let the partial differential equation be satisfied at that boundary. Barone-Adesi et al. ([2003](#)) use a Neumann boundary condition. Having experimented both alternatives, we align with Zvan et al. ([1998](#))'s choice which seems to be more robust.
3. A better solution would be to let θ^l depend on some economic indicators giving information about the financial difficulties of the policyholders such as the unemployment rate, rather than keeping it constant (see Kuo et al. [2003](#), Kim [2005](#)). However, the introduction of such variables considerably affects the simplicity of the model, since a new source of risk that cannot be hedged away should be taken into account.

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