Pricing in the New Frontier

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Pricing in 2010 and Beyond: The New Frontier

- Overview of presentations at the Society of Actuaries seminar, *Pricing in 2010 and Beyond: The New Frontier* by Oliver Wyman and Milliman, May 19, 2010
Topics

- Basic Concepts in the New Frontier
- Business Issues

Pricing Concepts

The Old World
- Pricing is largely formulaic
- Risk is measured by capital factors
- Traditional measures such as stat IRR and GAAP ROE rule
- Value creation is taken for granted

The New Frontier
- Pricing is more holistic and risk management is central
- Capital is recognized as lifeblood of organization
- Goal is to ensure efficient utilization of capital
- Value creation is scrutinized by senior management
- Economic measures are forming an additional lens
Traditional Pricing Flow

1. Calculate expected cash flows
2. Determine portfolio yields
3. Calculate reserve, capital, and tax flows
4. Calculate pricing metrics

Traditional Earnings and Value

1. Take financial leverage
   - Borrowing to invest
   - Borrow from policyholders
   - Invest for yields that exceed cost of borrowing
   - “Collateral” requirements are statutory reserve and capital
2. Create earnings
   - Credit, equity, and interest bets pay off most of time
   - Positive earnings most of the time
3. Call it value
   - Positive earnings good. Feed P/E ratio
   - Hard to distinguish quality of earnings
   - Is this efficient or expensive way to take financial risk?
Re-examination of Pricing Process

- Pushing toward more holistic pricing frameworks
- Questioning the value creation process
- Introducing economic measures
- Strengthening governance and controls

Pushing Toward More Holistic Pricing

- Assess customer and distributor value proposition
  - Product and guarantee offering
  - Customer and distribution value
- Assess insurer value proposition
  - Statutory – GAAP – Economic
  - Consider all stakeholders
    - Policyholders/creditors/rating agencies/regulators/management
  - Different perspective for different stakeholders
- Assess boundary constraints
  - Decision reflects hard and soft thresholds from all perspectives
Questioning the Value Creation Process

- Balance of risk between insurer and customer must be understood
  - Products that pass through investment risk can still be very risky for the insurer

Capital Utilization Must Be Understood

- Each product’s economic return must be understood
- Returns should be consistent across products to achieve efficient use of capital
Strengthen Governance and Processes

- Confirm pricing standards
- Risk management approval for new products
- Understand marginal impact of product on total portfolio
- Greater consideration of reputational and operational risks
- Linking total company perspectives on solvency to micro pricing decisions
- Consideration of the impact on board, rating agency, and regulator perspectives

Business Issues
Sources of Issues

- Recent Laws and Regulations
- Recent Outside Forces
- Future Regulation
- Possible Future Events

Recent Laws and Regulations

- Variable annuity reserving (AG XLIII)
- Pension Protection Act of 2006
- Interstate Insurance Product Regulation Commission (IIPRC or Interstate Compact)
Recent Outside Forces

- Financial crisis
- Rating agency tightening of capital requirements
- Gaming of complex products
- Limited financial solutions (XXX)
- Growing significance of Market Consistent Embedded Value (MCEV)

Future Regulation

- Restoring American Financial Stability Act of 2010 (RAFSA or Financial Reform) – still evolving
- Uncertain path of taxation
- C3-Phase IV
- Principle-based reserving
- Revised Standard Nonforfeiture Law
Possible Future Events

- Long-term Federal budget “balancing” efforts
- DOL/Treasury regulation to encourage Annuitization

The only Certainty is Change