

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**

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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

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Traditional Pricing Flow

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

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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?

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Re-examination of Pricing Process

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

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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

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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

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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**

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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

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Business Issues

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Sources of Issues

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

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Recent Laws and Regulations

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

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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)

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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

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Possible Future Events

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

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The only Certainty is Change

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