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Credit Card Approach to Pricing

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The traditional approach to pricing insurance products views pricing from the perspective of the insurance company. The author suggests viewing pricing from a different perspective—that of the customer—and demonstrates the approach by applying it to a product that is gaining in popularity —bonus annuities.

Basics of Pricing

Traditional pricing generally includes analysis of the statutory stream of earnings that is generated by a given product. The typical product will generate statutory losses in the early years. This constitutes the investment that the insurance company is making in the product. The insurance company sets the charges and fees in the product so it will earn an acceptable return on its investment. A general rule is that the larger the investment, the greater the charges and fees to recoup that investment.

For example, assume a $100 single premium variable annuity with a 5% commission, no surrender charges and no other expenses or required surplus and an intitial reserve, account value and surrender value of $100. The company will lose $5 on a statutory basis. The company has invested $5, and the shareholders expect that amount to be returned with interest. Charges and fees in the product will be set such that the expected return over all policies sold will provide at least that return.

Insurance companies typically set their after-tax rates of return in the 10%-15% range. This translates into a 15%-23% pre-tax rate of return using a 35% effective federal income tax rate.

The Credit Card Approach to Pricing

The above approach is pricing from the perspective of the insurance company. From the perspective of the customer, the pricing described above can be viewed as the insurance company taking the statutory losses for a policy and putting them on a credit card that the client is expected to pay back with interest over the life of the policy. The charges and fees in the product are applied as credits to pay down the outstanding balance.

Customer balances are charged with interest at the rate of 15%-23%. These rates are as high, if not higher, than most credit cards. In fact, many credit cards are available that charge rates less than 10%, significantly lower than the 15%-23% implicitly charged by insurance companies.

The analogy to credit cards becomes more disadvantageous for the insurance customer relative to the credit card holder. Credit card holders are only responsible for their own account balances. If someone defaults, the balance is not apportioned among the remaining holders. However, in the case of insurance any defaulted outstanding balances are, in effect, allocated to the remaining policyholders. This is because the insurance company has a goal of an overall return, say 15% pre-tax. If they charge all clients 15% and some clients lapse or die without completely paying off those balances, those balances must be allocated to the remaining policyholders, who must continue to pay 15% on their now-higher balances. If not for this reallocation, the overall return would be less than the 15% target.

In addition, the customer would continue to make payments as long as the policy remains in force, even if the "balance" had been fully repaid. These extra payments may result in lower charges for other customers.

Implications for Product Design

Most insurance clients have access to credit at rates that are less than or equal to those implicitly charged by insurance companies. Many clients can access home equity loans and realize after-tax rates that are currently around 5%-7%. Interest implicit in insurance products is not currently tax-deductible.

Consequently, for the long-term client who can pay the up-front expenses or who has access to less expensive sources of credit, a product that removes those up-front expenses from the policy immediately would be preferrable to one where the insurance company "loans" the statutory losses and recoups them over time.

Products designed for the higher net income and corporate markets generally pass-through initial costs, such as commissions, state premium tax, and the Deferred Acquistion Cost (DAC) tax. These clients can afford to pay the front-end costs and will receive significantly better long-term performance. Informed clients understand that paying these costs up-front is better than taking a loan from the insurance company.

Application to 'Bonus' Products

'Bonus' type products are currently popular among many agents and their customers. However, close analysis of the operations of these products reveals that in many situations these products are not appropriate for long-term clients.

Recently, annuity products have been developed that credit bonuses to the account value that are in excess of the premium paid. These products have an obvious appeal both to the agent and to the customer. The sale is made much easier for the agent. Who can object to getting an immediate return on their investment? Early account values are

clearly higher than products that do not credit bonuses. Customers see higher early values and are told that these products are better because they "have more money working for them." The author will demonstrate that that additional money is not working for the client but is working for the insurance company.

Recent Bonus Products

A typical bonus annuity will pay an additional 3% or 4% of the premium into the account value. This bonus is not immediately available to the client. Surrender charges are generally higher and longer than for non-bonus counterparts. Charges, such as the mortality & expense charges (M&E), are higher than non-bonus counterparts by 20 to 50 basis points. A variation on this product does not increase the charges to the client. Rather, there is a dollar-for-dollar decrease in the commissions paid to the agent.

The popularity of these products is growing as more companies introduce them, and the market share of these products is growing rapidly. Recent articles in major publications, such as the *Wall Street Journal,* illustrate the growing public awareness of and exposure to these products.

Implications for Bonus Products

Bonus products operate in exactly the opposite way than products for higher income and corporate clients. Instead of paying the front-end fees and eliminating any loan balance, bonus products actually increase the loan from the insurance company to the client. Essentially, the entire bonus is added to the loan balance.

If, in the above example, a 3% bonus were added to the account value, that 3% bonus would increase the statutory loss from $5 to $8. Charges and fees would have to be increased to recover this additional loss.

The client is deceived into thinking that the bonus is "working for him." However, the bonus is working for the insurance company. The client may invest that bonus in variable subaccounts that may earn on average 10% over the long-term but is paying between 15%-23% to the insurance company for that privilege.

Regulation of Bonus Products

In general, bonus products are deceptive. The author believes that the appropriate regulatory response is not to outright ban such products. There may be situations in which they are appropriate. However, for an agent and a client to adequately determine whether such a product is appropriate, sufficient disclosure is necessary. Disclosure should point out that bonuses are not free, and that they are paid back with interest. The implicit interest rate should be either disclosed or discussed in enough detail so a potential client can compare rates to other sources of funds. In addition, discussion of how losses on other policies are, in effect, paid for by remaining customers should be included.

One approach would be to explicitly state the first year statutory loss generated by a policy and the rate of interest implicit in the pricing of the product. Currently, the illustration actuary must submit a report to the board of directors on various pricing aspects of products available for sale. The profitability goal is generally part of that report. Statutory losses by pricing cell are available or can be generated. If these items were disclosed to the client, the client could compare products.

In our example, the disclosure might be:

Product A (no bonus)	$5 balance	15% interest rate
Product B (bonus)	$8 balance	15% interest rate

The client might assume that the bonus earns 10%. If so, then for Product B, the net cost would be 5% on the $3 bonus portion and 15% on the remaining $5. The client would probably choose Product A. There is no need to borrow money just to lose interest on it. That would be similar to taking a loan and leaving the money in a non-interest earning checking account. An illustration of cash values under different interests rates would be a useful tool to compare products.

If a product were available with front-end loads where it had little or no M & E charges that product might appeal to a client who had access to inexpensive sources of funds.

For example, Product C has a 5% premium load to cover the 5% commission. A client would pay $105.26 into the policy to have $100 invested. If the $5.26 was taken from a source that had a low cost, Product C would be preferrable to both Products A and B. There would be no balance with the insurance company on which to pay interest, only the $5.26 initial load.

The author clearly has a bias towards products where initial expenses are paid for from initial loads. In such situations, the client is only responsible for his/her own initial expenses and does not pay high implicit rates of return. The author believes that many clients would be better served if they were better informed on how bonus and non-bonus products are priced. Better disclosure will lead to better customers.

Insurance products have tremendous value. This value does not have to be exaggerated to attract clients. Products that focus on long-term client needs can be sold and can achieve profitability. Deceptive products may increase sales at some companies in the short run but hurt the entire industry's image in the long run.

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