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Product Pricing in the Year 2010

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Given that it is the start of a new year, there is an abundance of prognosticators looking into their crystal balls trying to predict the future. I do not have a crystal ball, but a clear look at current trends shows me five areas where pricing actuaries should expect changes in how we will price life insurance products by 2010.

Interaction between Pricing and Corporate

There is a move toward principle-based reserving standards in the United States. Regulation XXX and C3 Phase 2-type reserves for variable annuities are two examples of principle-based reserving. Five years from now, there will be greater use of principle-based valuation standards.

A key element of principle-based valuation standards is the use of "prudent best estimate" assumptions. Product development actuaries will need to ensure that the best estimate assumptions and margins for adverse deviation used in setting reserves in the pricing process are consistent with that of their corporate actuary. They will also need to be aware of the impact of changes in assumptions on reserves, and consequently on profitability, and be prepared to work in tandem with corporate actuarial in reacting to changes in these assumptions.

Changes in Use of Reinsurance in Pricing

The U.S. life industry has become increasingly reliant on reinsurance. Over 60 percent of new face amount was ceded to reinsurers in 2003. However, there are many factors that are driving up the cost of reinsurance today. These include changing views on long-term mortality costs, market consolidation and concerns over letter of credit (LOC) capacity. In addition to the increased cost of reinsurance, direct writers are also concerned about reinsurer credit exposure.

Life insurers will look more closely at the drivers of reinsurance use, e.g., transfer of mortality risk, capital management, and, where practical, consider alternatives to reinsurance. This could result in a decrease in the use of bundled reinsurance solutions, e.g., coinsurance, and an increase in the use of reinsurance for a specific risk, yearly renewable term and transfer of mortality risk.

Capital Markets Arbitrage

The capital markets' interest in the life insurance industry has grown in recent years, providing the industry with new sources of capital. However, the capital markets' interest in life insurance is not limited to providing capital. As the capital markets become more familiar with the life insurance industry, they will uncover and exploit arbitrage opportunities.

The life insurance industry has always been susceptible to the exploitation of uneven pricing. Typically, distribution systems will find and exploit areas where a company has underpriced policies relative to the competition. However, the amount of monies that the capital markets can direct toward an arbitrage opportunity, and the short amount of time that they require to accumulate these monies, is many times greater and faster than what most distribution systems can direct toward an arbitrage opportunity. Recent evidence of this can be seen with "life insurance life annuity combination" transactions (LILACs). Pricing actuaries will need to be more vigilant when it comes to identifying and eliminating arbitrage opportunities.

Risk Analysis and Pricing Systems

As risk management practices become more evolved, there will be increased attention paid to low probability/high impact risk in products. Products with complex risks or embedded options will need to be fully analyzed prior to going to market. Companies will require that risks within these products are identified, quantified and mitigated as much as possible during the product development process. In order to quantify these risks, pricing systems will require functionality that many of today's systems do not have, e.g., stochastic-on-stochastic projections. The pricing systems of the future will need to combine flexibility and speed to meet the needs of pricing actuaries.

Demographics

As with all business, the life insurance industry in 2010 will be shaped by demographic forces. There will be a continued increase in the number of older age persons living in the United States and Canada. This will result in more pressure to increase issue age limits and to accumulate better information regarding older age mortality, and more broadly, older age policyholder behavior. The aging of the baby boom generation will also impact the distribution of life insurance sales. However, we do not expect a major shift in product preference in the next five years due to the aging of baby boomers, as they will have not yet reached the age where payout annuities and other wealth transfer products are attractive.

Of course these predictions are routed in what we see today as emerging issues in the market. By 2010, we will see if they truly change how we as pricing actuaries work on a day-to-day basis. ☐

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