Society of Actuaries

Article from:

Product Matters!

June 2011 – Issue 80

Question to the Editor

I found your article "Is this Correction Good for Life Insurance?" in the recent issue of *Product Matters!* very interesting. My feeling is that 'hope strategy' you refer to is driven by more than just general optimism, but by companies' fear of pricing themselves out of their desired competitive position. Do you have any comments on balancing the strong tensions between beginning the de-risking process ahead of the market versus maintaining a competitive product?

Product Matters! Reader

Response from Ross Zilber, author of "Is this Correction Good for Life Insurance?" published in the February 2011 issue of *Product Matters!*

Insurance distribution systems have steadily moved away from the captive channel. This move reduced distribution costs but had a profound effect on producer loyalty and cost of underwriting. Placement ratios (percent of underwritten applications that were actually placed) in the Brokerage space are in the range of 25- to 40-percent, while in the captive force it is still about 70 percent. In the brokerage channel about 30 percent of business is placed with their number one carrier. The strategy of "keeping the foot in the distribution" does not agree with the paradigm of the Brokerage channel. Just ask your loyal BGA how much your NLG sales will drop off if the product loses a competitive position.

I believe your question touches more on psychological biases. There is an interesting reading on the third CFA exam about heuristic biases by Hersh Shefrin. These psychological biases tend to stand in the way of making objective decisions. I will comment on two biases—overconfidence and loss aversion.

Overconfidence materializes when management places too much confidence in their ability to predict the future. I have dealt with predictions about interest rates in the article. But there are also predictions about inefficiency of policyholder behavior. These assumptions are usually not based on credible data, and extrapolate future policyholder behavior from the period of benign economic environment. Assuming inefficient policyholder behavior would greatly reduce value of interest rate options in the products. These assumptions provide management with the tools to show better profit and risk profiles of the product, and hence remain in the market.

Loss aversion is the reluctance to accept a loss. This should not be confused with risk aversion, as often loss aversion actually leads to taking more risk at underpriced levels. Management is often reluctant to reduce competitiveness of the product, as sales stop coming in. This usually implies that expenses need to be brought down as well, which leads to difficult decisions. There might be negative short term financial and career consequences.