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Pricing in a Low Interest Rate Environment

By Terry Long

Due to the decrease in interest rates over the last several years, the maximum valuation interest rate for long duration life insurance (greater than 20 years) decreased from 4 percent to 3.5 percent effective for policies issued in 2013. By now, most companies have made changes to their valuation systems to support the new valuation interest rate.

The reduction in the maximum valuation rate also resulted in a decrease in the maximum nonforfeiture interest rate. With the new 3.5 percent valuation rate, the maximum nonforfeiture rate has decreased from 5 percent to 4.5 percent. Unlike the valuation interest rate, however, there is a one-year grace period for implementation of the nonforfeiture interest rate. The new 4.5 percent maximum nonforfeiture interest rate is optional for 2013 issues but will be mandatory for 2014 issues. Some companies have already implemented cash values based on the new maximum interest rate, but many are electing the one-year deferral. While there is no requirement that gross premiums change, most companies are repricing their products at the same time they implement new cash values.

- The lower valuation and nonforfeiture interest rates will result in larger basic reserves and cash values, which in turn will lead to increased surplus strain and reduced profit margins.

- Products that previously required deficiency reserves will likely require greater deficiency reserves in 2013 if gross premiums remain the same.

- Products that were not deficient in 2012 may now be deficient due to the larger net premiums and minimum reserves.

- Most importantly, the reduction in interest rates that led to the reduction in the valuation interest rate has also resulted in actual investment yields being lower, often significantly lower, than those assumed in pricing.

Pricing Considerations

Pricing a product in the current low interest rate environment provides a challenge that most of us have not experienced. While we have experienced declining interest rates for a number of years, the general outlook was that they would soon level out or increase. Current indications are we will continue in the current environment for at least another year or two, and possibly longer depending on actions taken by the Federal Reserve.

- Should the pricing actuary assume that in the long term interest rates will increase and return to traditional levels? This will allow for more aggressive and competitive pricing, but there are obvious risks. If interest rates do not increase as quickly or as much as assumed in pricing, reduced profitability or even losses are possible.

- There is also the opinion of some that lower interest rates are the "new normal" and that products should be priced accordingly. While this approach will reduce or eliminate losses on the investment income assumption, it will also make it harder to compete with products that are priced differently.

Profit objectives are another factor companies are reviewing. Companies using internal rate of return (IRR) as a measure are evaluating whether they need to change their target. One justification is that historical IRR measures could be viewed as the then-current interest rates plus a risk premium. Under this assumption, a reduction in the underlying interest rates would justify a lower IRR. Selling this to senior management, however, can be a challenge.

Agent compensation is another area to review. While relatively few companies may have implemented more level commissions, pressure to do so is increasing.

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Product Considerations

Companies are also reviewing the products they offer. Are there products that can be eliminated? Should new types of products be added to the portfolio? Some of the changes that have been made over the past few years include:

- Products that depend on interest spread, such as accumulation universal life, have become less favorable both for companies and consumers.
- Protection products, such as term insurance and universal life with secondary guarantees (ULSG), continue to be popular. But they have their own risks such as capital strain, long-term persistency risk for ULSG, and long-range mortality projections.
- Traditional whole life products have become more popular with consumers due to the guaranteed cash values. Low interest rates, however, are pushing companies to increase premiums and/or decrease dividends on the new products being introduced.
- Indexed products are also becoming more popular, but due to investment and marketing complexities, not all companies are in a position to enter this market.

Planning for These Changes

If they have not already been made, decisions on how to proceed should be finalized soon. In addition to developing new products, changes to administrative, valuation and illustration systems will need to be made. These will require concerted efforts by marketing, actuarial and IT departments to have everything in place by the end of the year. Legal and compliance divisions will also be busy filing new and updated products. Since most companies will be filing multiple products this year, state insurance departments will be under more pressure. In response, a number of insurance departments have implemented procedures to help streamline the process for filings that involve changes due only to changes in the valuation or nonforfeiture interest rates.

Terry Long, FSA, MAAA, is senior vice president and consulting actuary with Lewis & Ellis in Overland Park, Kan. He can be reached at *tlong@lewisellis.com.*