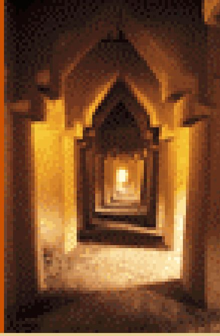
Life Insurance in a Fair Value World

A Presentation for the International Actuarial Congress in Cancun Mexico in March 2002

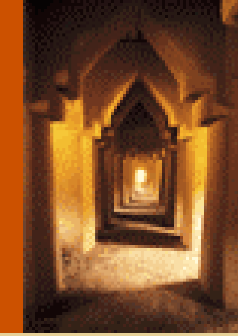
by Sam Gutterman and Nigel Masters

Setting the Scene



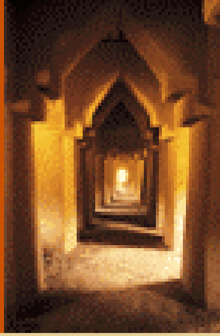
- Over the next decade:
  - A new IFRS for insurance (and investment) contracts
  - US GAAP starts to converge?
  - Solvency regime is risk based and integrated with prospective valuation
  - Coherent financial management possible

What is a coherent financial structure?



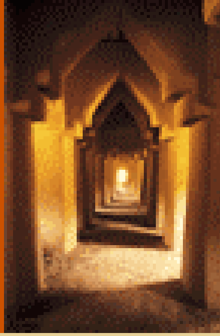
- The insurer chooses the level of creditworthiness that optimises the volume of business in the target market
- The insurer holds sufficient capital to cover the level of risk implied by the target creditworthiness
- Premiums and charges are set to service the costs of the capital at risk
  - And customers are prepared to pay those premiums and charges for the level of creditworthiness offered by the insurer
- Key strategic decision is the optimum level of creditworthiness for the target market

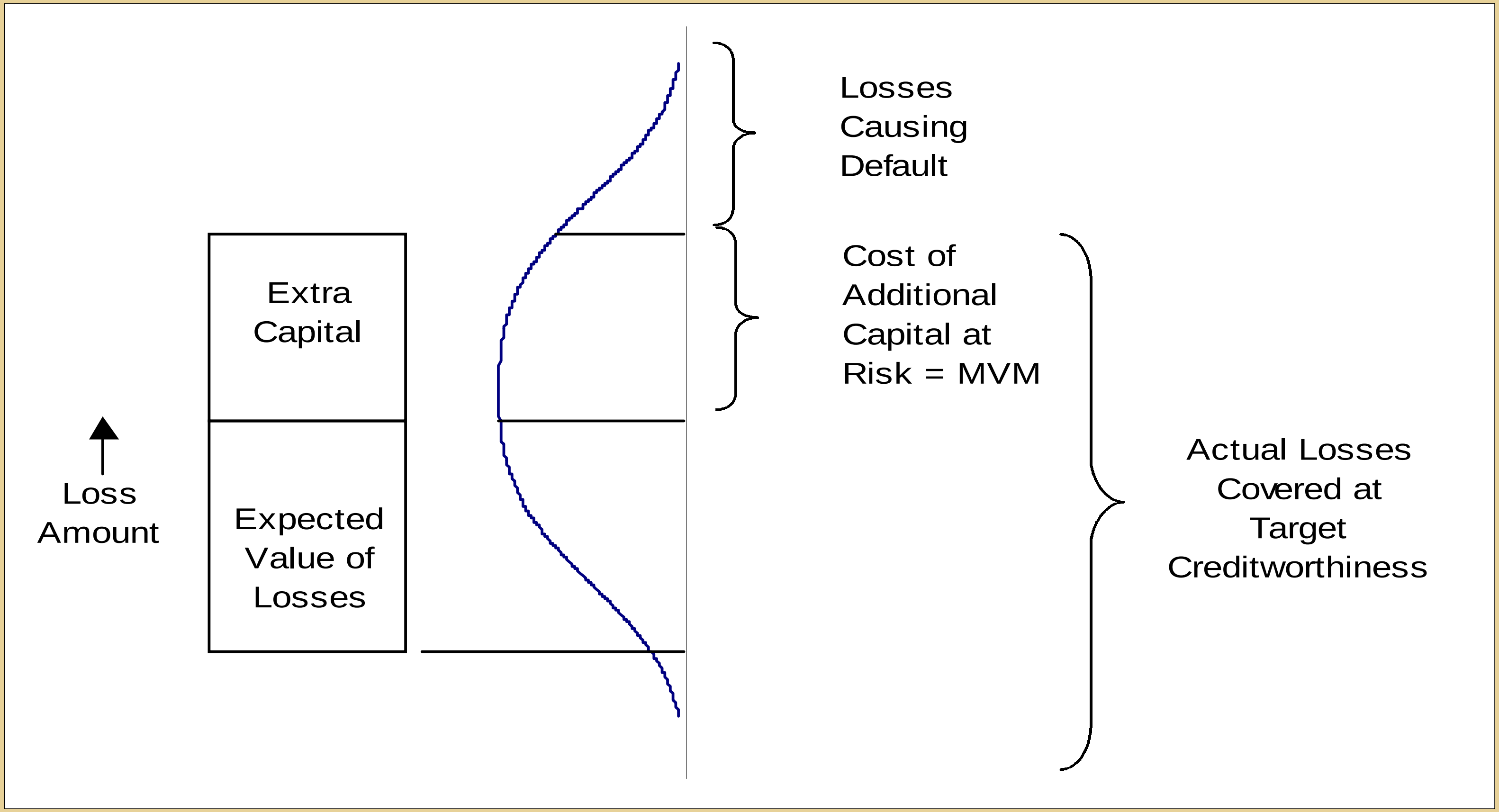
Coherence and MVM’s



- How to fair value a portfolio in a coherent structure?
- Fair values depend on Market Value Margins (“MVM’s”)
  - MVM’s are the price that the market requires to cover the risks
- But what level of risks?
  - The same as the creditworthiness of the insurer (if policyholders and capital markets share the same risk aversion)
- What is the price for this level of risk?
  - The cost of servicing the capital at risk

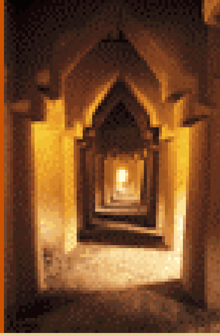
Coherence and MVM's





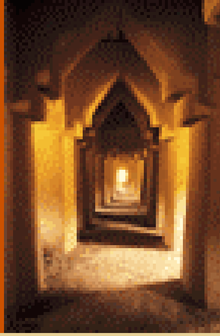
The Practical Impact of a Coherent Fair Value World

Financial reporting in a fair value world



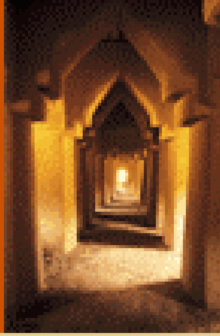
- Value of New Business
  - Fair value of new policies
  - (Acquisition costs)
- Value from Existing Business
  - (Actual – Expected Benefits)
  - (Actual – Expected Maintenance Expenses)
  - Change in value due to change in assumptions
- Value from Financial and other activities

Drivers of New Business Earnings



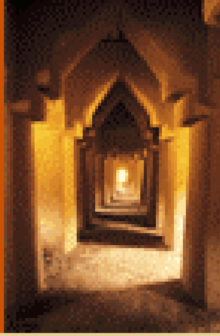
- Adequate premiums and charges
- Reduced by
  - Expected cost of guarantees and options
  - Investment performance in pricing but not recognisable
  - Uncertainty in the statistical base
  - Renewals in pricing but not recognisable (but good for future new business)
  - Treatment of Constructive Obligations

Managing Existing Business



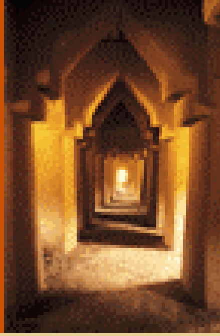
- Investment strategy
  - Equity returns may be leveraged risk
  - Shareholders to regain excess capital
  - Separation of investment and insurance businesses
- Management of lapse rates
  - Dialogue to improve retention
  - Client Relationship Management
  - Value recognized immediately

Managing Existing Business



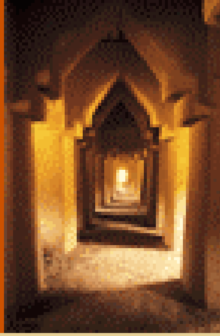
- Administration Costs
  - Spotlights costs and overruns
  - Reduce cross-subsidy from investment returns
  - Third Party Administration ('TPA')
    - Managing service levels
    - Risk management
    - Counterparty strength

Managing Existing Business



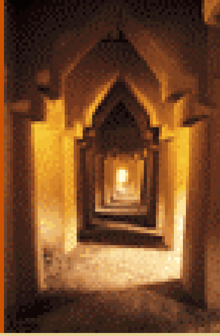
- Managing financial risk
  - Stability of current reporting regime means risk management is largely unnoticed and ignored
  - Asset/Liability management
  - New regime needs active Treasury management
  - Securitisation gets larger market led by reinsurers?
  - Greater sophistication required
  - Personnel and systems infrastructure

Managing Existing Risk



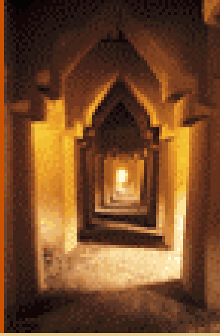
- Analysis of Added Value
  - Income statement requires ‘Actual versus Expected’
  - Management information on timely basis
  - Analysis may be difficult to audit
  - Integrate general ledgers and model offices

Managing Existing Business



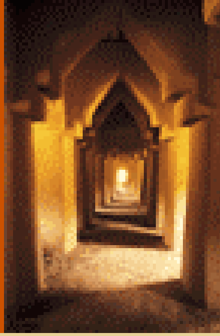
- Risk management
  - Source of competitive advantage
  - Management of Operational Risk
  - Credit rating agencies
  - New focus by Regulators
  - Internal risk models

Managing Existing Business



- Managing Participating Business
  - New approach to participation
  - Policyholder bonus accounts?
  - Review national legal requirements
  - Transparency between generations
- Taxation

Summary



- Coherence comes from consistent view of creditworthiness
  - Corporate objectives – integration of desired surplus and competitive premium levels
- MVM’s based on cost of capital required for target credit rating
- Risk management will be a source of competitive advantage
  - Through product design
  - Through close control of existing administration
  - Through financial risk management
  - Through operational risk management
- New winners, New losers.

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