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Aligning Proper Incentives with Decision-Making

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The economic crisis and life insurance

The crisis impacted life insurers in a number of ways – primarily through the availability of capital and enhanced regulatory considerations.

<u>A multiple choice question</u>

No major insurance went under as a result of the crisis. Why?

A. Better use of models in life insurance to project and analyze risk

B. Existing capital requirements (RBC) were sufficient

C. Long-term horizon of life insurance meant companies had more time to react and course correct

D. Non-elective nature of many life insurance benefits mitigated effects

E. Life insurance companies were just lucky

F. Life insurance actuaries and CROs are the rock stars of risk management

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What's different about life insurance?

- Long-term nature of life insurance
  - Mismatch between natural profit horizon (10 years, 30 years or more) and short-term focus of market
- Complex interaction of assets and liabilities
  - Mismatch between liquid market-traded assets and illiquid liabilities
- Complex product design
  - Commingling market risks, non-elective mortality / morbidity risks and elective policyholder behavior risks

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Performance measurement in life insurance

There are a number of different metrics that companies use in measuring performance

Current period metrics	■ Measure the performance over the past financial period (year or quarter) or at the current time ■ Directly observable from financial statements or internal reports based on standard accounting approaches ■ Include profit, revenue, stock price, capital, ROE, ROIC
Prospective metrics	■ Measure the profitability or value inherent in the company's current book of business that will be released in future periods and the change in that prospective value in the current period ■ Must be calculated using forward-looking models ■ Include economic capital, embedded value, RAROC

The choice of metrics in incentive comp has a significant impact on the behavior of employees / management

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Use of prospective metrics in incentive comp

While prospective metrics are critical to effective performance measurement in order to bridge the gap between short-term market focus and long-term profitability, they are challenging to implement

Pros

- Better alignment with long-term horizon and profit patterns of life insurance
- Mitigates short-term focus on current period profitability

Cons

- Requires assumptions for forward-looking projections
  - Who sets the assumptions?
  - Who controls the models?
- Hard for employees to understand
- Which calculation methods and bases should be used?
  - Stat, GAAP, Economic

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Getting comfortable with estimates

Every prospective metric – and even current state measures – have some prospective view of risk baked into them

Which metric feels more comfortable?

12/31/2011 statutory net income from the published blue book	12/31/2011 Economic Capital run under 10,000 stochastic scenarios with 20 deterministic shock scenarios for the company's top 20 risks

- Current period profits include an item for the change in reserve – which is an estimate
  - However, this is usually viewed as more "reliable" as the estimate is based on accounting standards
- Which view of risk is more "realistic"?
  - Economic vs. GAAP vs. Statutory

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Conclusion and Recommendations

Inclusion of prospective metrics provides an enhanced framework for managing incentives and is worth the additional effort required for implementation

1. Use a combination of metrics in a holistic framework to drive incentives
   - Should be aligned with stakeholders' view of risk and return trade-offs
   - Stakeholders with a short-term focus will want more current period metrics (although perhaps they shouldn't be investing in life insurance companies?)
   - Stakeholders with a long-term focus will want more prospective metrics
2. Align incentive comp metrics for individuals with how performance is measured and reported for the company as a whole
   - Eliminates misalignment between company strategy and individual incentives
3. Ensure that prospective metrics are calculated in a controlled environment with appropriate delegation of authority, policies, and change management protocols
   - May need to provide different incentive plan for the people doing the calculations

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