Office of the Superintendent of Financial Institutions Canada
Canada

Bureau du surintendant des institutions financières
Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

255, rue Albert
Ottawa, Canada
K1A 0H2

Guideline

Subject: Standards of Sound Business and Financial Practices -- Product Design and Pricing Management

No: F-7 **Date: February 1998**

A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place to prudently manage and control its product design and pricing risks.

The nature of certain life and health insurance products involves commitments by the company to provide financial obligations and insurance coverage for extended periods of time. Experience indicates that the quality of product design and pricing goes hand in hand with financial soundness.

This guideline focuses on a company's responsibility for managing and controlling the product design and pricing risk. It is intended to cover all products issued, including life, health and annuities on either a group or individual basis. It is not intended to imply that product design and pricing can be managed in isolation from the capital management, investment underwriting and claims, or marketing policy of the company.

B. DEFINITION

Product design and pricing risk is the exposure to financial loss resulting from transacting insurance and annuity business where the costs and liabilities assumed in respect of a product line exceed the expectation in pricing the product line.

C. PRODUCT DESIGN AND PRICING MANAGEMENT PROGRAM

Managing product design and pricing is a fundamental component in the safe and sound management of a company. Sound product design and pricing management involves prudently managing the company's risk/reward relationship and controlling product risk across a variety of dimensions, such as concentration, anti-selection, misrepresentation, adverse experience, currency and ongoing service and maintenance.

Although the particulars of product design and pricing management will differ among companies depending upon the nature and the complexity of their products and the manner in which they are marketed and serviced, a comprehensive product design and pricing management program requires:

- identifying new product lines and material pricing, or product changes to product lines

    - which are currently being offered, or proposed to be offered by the company in conducting its business activities, and/or

    - which provide for an adjustment in the price charged, financial arrangement provided, investment income credited or fees assessed

and developing product design and pricing policies to effectively manage and control them;

- developing, documenting and implementing effective processes for the introduction of a new product, or material change to an existing product; and

- developing and implementing comprehensive procedures to effectively monitor and control the nature, characteristics and quality of products.

Product Design and Pricing Risk Management Policies

The foundation of an effective product design and pricing risk management program is the identification of the existing and potential risks inherent in a company's product offerings and pricing levels, and the maintenance of clearly defined policies, formally established in writing, that set out the product design and pricing philosophy of the institution and the parameters under which the product design and pricing risk are to be controlled.

Pressure for increased profitability, marketing considerations and technological advances have led to more innovative and creative products. The long term nature of certain products, the consequences of which are not fully known at issue, represent a unique risk to the insurance industry. Measuring the risks attached to each new product, material product change or pricing change permits the determination of aggregate exposures for control and reporting purposes.

Product design and pricing policies establish the framework for offering products to the customer and indicate the company's culture and marketing strategy. To be effective, policies must be communicated in a timely fashion, be implemented through all levels of the organization by appropriate procedures and revised periodically in light of changing circumstances.

Product design and pricing policies need to contain:

- a product design and pricing philosophy governing the extent to which the company is willing to assume the product design and pricing risk;
- product lines in which the company is prepared to engage or is restricted from engaging;
- clearly defined and appropriate levels of delegation for approval of all material product design and pricing changes; and
- sound and prudent product concentration limits.

i) Product Design and Pricing Risk Philosophy

The product design and pricing philosophy is a statement of principles that outlines a company's willingness to assume product design and pricing risk and will vary with the nature and complexity of its business, the extent of the risk assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

ii) Product Lines

The product lines in which a company is prepared to engage or is restricted from engaging would usually specify:

- whether the policyholders would have voting rights;
- whether the policyholders would have rights to participation of profits, experience rating, or some other form of risk participation;
- the nature of the risk undertaken;
- the target customer profile and the needs that the related products are intended to satisfy; and
- the manner in which the product will be delivered or distribution approach.

iii) Approval Authorities

Clearly defined and appropriate levels of authority for product design and pricing approval help to ensure that such decisions are prudent and acceptable, that the integrity and credibility of the process is fair, consistent and objective, and that, given the expected return, the risk is acceptable.

The approval process needs to ensure:

- satisfaction that systems and administrative procedures are in place;
- satisfaction that requirements regarding product illustration, service and sales staff training, presentation and contract materials, have been met;
- satisfaction that corporate objectives with regard to use of capital and returns on capital have been met; and
- satisfaction that the underwriting and claims control procedures that are in place are compatible with the design of the applicable product.

Authorities may be absolute, incremental or a combination thereof and may also be individual, pooled or shared within a committee, recognizing the experience of the officers.

The delegation of authority needs to be clearly documented and should include:

- the authority being delegated;
- the officers or positions or committees to whom authority is being delegated;
- the ability of recipients to further delegate; and
- any restrictions.

In particular, because of the authority and responsibility given to the appointed actuary or valuation actuary, his/her role in the approval process needs to be clearly defined.

iv) Product Concentration Limits

Concentration occurs when a product portfolio contains excessive exposure to:

- a geographic region;
- a type of product;
- a distribution system or facility;
- an industry;
- specific health or demographic characteristics;

- a single individual or group;
- a number of associated individuals or organizations; or
- any other specific risk profile.

Reinsurance is one method to minimize certain concentration risks. Diversification policies should be stated clearly and include portfolio goals.

Product Design and Pricing Analysis and Documentation

The most significant risk that a company faces is issuing policies where the value of the costs and liabilities assumed exceeds the value of the price charged for such a product line.

To minimize its exposure, the company should give proper consideration to, and conduct an assessment of, each new product or material product change or pricing change prior to approval and ensure such reviews are appropriately documented.

Assessment documentation should set out the process to be followed for risk identification, risk limitation, and risk measurement.

Risk identification would include assessment of the exposure to such items as:

- mortality and/or morbidity risk;
- lapse and surrender risk;
- interest rate risk;
- inflation risk;
- anti-selection risk;
- option risk;
- contingent risk;
- distribution system risk;
- technological risk;

- volume of business risk;
- competitive positioning risk; and
- asset risk.

Risk limitation addresses how management intends to control or limit the risks that have been identified. Examples could include, but are not limited to:

- the requirements and limitations on the amount retained on one life or group;
- handling of special risk groups through ratings, policy restrictions or alternative financial arrangements;
- where premiums are reviewed annually, or adjustable, how emerging experience would be reflected in price adjustments;
- retrospective rating, or limitations on experience rating refunds;
- how the company would respond to competitive pressures; and
- reinsurance.

Measurement of the risk involves a quantification and documentation of the financial impact involving:

- sensitivity testing;
- risk and return trade-off; and
- capital requirements.

Product Design and Pricing Monitoring and Control

Establishing adequate procedures to effectively monitor and control the product design and pricing function within established guidelines has been found to be an effective method of limiting financial exposure for companies. The appointed actuary's report on the financial condition of the company provides an existing source for identification and monitoring of existing and potential exposures.

A company needs to develop and implement comprehensive procedures and information systems to effectively monitor and control product development and pricing. These procedures need to define prudent criteria for identifying and reporting potential problems, followed up with appropriate corrective action.

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