The Introduction of Cash flow-based Financial Pricing to the Insurance Industry: Its Impacts and Challenges

Traditional actuarial pricing has tended to view the insurance firm too much from within. It focuses mainly on the insurance supply, especially claim costs which include safety margins in traditional pricing. Other factors such as cost of capital, investment earnings, and the insurance demand are just implicitly considered in traditional pricing. However, cash flow-based financial pricing demands that insurers consider explicitly all the expenses as well as the insurance demand. Therefore, an insurer can set the target premium of an insurance product by financial pricing and test its profitability in advance whereas an insurer using traditional pricing can only test the profitability after the sale of an insurance product.

In addition, regulatory changes have made insurers try more flexible pricing methods than traditional pricing: New solvency test and New accounting principles. Newly implemented solvency test, the Risk-based Capital requires insurers to explicitly consider asset risks to which they are exposed, and also new accounting principles (e.g. IFRS 4 phase 2) is expected to require the separation of claim costs from risk margins when insurers value their insurance liabilities. It is expected that cash flow-based financial pricing could satisfy those requirements.

The purpose of this study is to analyze the impacts of new pricing on the management of insurance business and to show the challenges for the smooth transition to cash flow-based financial pricing.