Prudent Hedging

By Editor Test *Wed, Jun 2, 2010*

Daniel O. Kane is the chief actuary at Prudential Annuities, where one of his primary chores is to manage the risks of the Highest Daily 6, Prudential's flagship variable annuity with a lifetime income guarantee. He called the current interest rate "sustainable." His worst-case scenario: A Japan-like "lost decade." "We do a lot of hedging... Read more »

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"We do a lot of hedging our benefits, primarily to offset the long-range interest rate risk. For us, at the company level, interest rates that are either too high or too low are risky. The most risk is on the low end. The guarantees we're making are more valuable to the customer when interest rates drop."

"If interest rates go up, it produces another risk," he said. Besides buying hedges, Prudential supports the income guarantees in its the Highest Daily 6 product by shifting account assets out of equities and into a fixed income account when equity prices fall. A sharp rise in rates would hurt that account.

"In the short term, it reduces the value of that account. But there are countervailing effects. The bond value may drop initially but on a long-term basis you now have more income earned going forward. So from a long-term liability perspective, higher rates help. If you're discounting that liability they can also help."

"We do hedge our interest rate risk. Rho is interest rate risk, and we manage it primarily by buying interest rate swaps. There's a reserve associated with it so we calculate a liability and record it in our financial statements.

"Regarding our obligation to make lifetime payments, we enter into swaps and buy equity and interest rate derivatives. Everything else being equal, the lower the interest rates the higher the hedge costs. We and others in the [variable annuity] industry have reduced the guarantees not only because equities didn't perform well but also because interest rates have gone down.

"The worst case for us would be a Japan-like scenario where you have 15 years of the equity market being down 70%, and interest rates at one percent. That scenario isn't good for any insurance company because all of the long-dated liabilities. The situation in the U.S. was extreme a year ago. Toward end of 2008 interest rates were low and the market was down, and that was an extreme environment. We are currently in a sustainable environment."

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