Risk Management For The Individual: The Key To Life Insurer Success In 2020 And Beyond

by Ken Beckman

Enterprise risk management continues to be a major focus in many industries and the life insurance sector is no exception. In fact, an insurance company's future survival is highly dependent upon the ability to successfully manage its various risks. However, to thrive and not just survive, an insurance company must take advantage of its expertise in risk management by also addressing the risks faced by its individual customers in a much better and more comprehensive way than is done today. This can be accomplished through the development of a single product that will allow individuals and families to simultaneously identify and manage the risks encountered over a lifetime. Companies that can successfully develop such a product will see profitable growth and become the dominant force in the life insurance sector of the future.

The value derived from human capital allows individuals to meet basic needs such as food, clothing, housing, education and health care, both during the working years and in retirement. The three primary risks in attempting to meet these needs are:

- Mortality (premature death and longer than expected lifespan),
- Morbidity (disability, extended later life health issues requiring assisted living and long-term care and conditions currently covered by comprehensive health benefit plans), and
- Investment risk (the risk of loss to retirement and personal investments).

Although these risks are well known, for a variety of reasons individuals often do not or cannot protect themselves. For example, assuming one saves enough of current earnings for retirement, investment risk is still a large obstacle in achieving a desired retirement income. This risk has increased recently by the rapid decline of defined benefit pension plans. Most participants in defined contribution plans have limited investment knowledge and often make unwise choices when investing large sums of money. Even those who receive investment advice or choose life-cycle funds have no guarantee that future required returns will be achieved. Although certain complex and costly option strategies could be employed, there is no product that currently offers an easy-to-understand and affordable way for the average person to purchase insurance protecting the value of retirement or personal investments.

Furthermore, even though the insurance sector currently does offer a vast array of products to mitigate mortality and morbidity, separate policies must be researched and purchased to cover the variety of risks that exist. For example, to protect against the morbidity risk one would need medical insurance, disability insurance and long-term care. Consumers and their agents spend valuable time trying to understand and compare features and costs from a laundry list of products rather than making optimal risk-based decisions that maximize insurance protection and minimize cost. This is due to both tradition and regulation, but it results in many consumers feeling frustrated with the process and purchasing products they may not fully understand and that do not efficiently cover all the primary risks. Without any significant industry change, as technology improves the ability to compare costs and product features, the insurance products as offered in today's market will become commodities, limiting opportunities for future growth.

To grow in the year 2020 and beyond, life insurers will need to become personal risk managers for their customers rather than just a place where insurance policies are sold. Successful companies will offer a policy that provides comprehensive risk management services for individuals and families. The product will offer lifetime protection from all the primary risks in a single insurance policy using the following coverages:

- Life insurance,
- Longevity insurance (i.e., guaranteed lifetime retirement income payments),
- Disability insurance,
- Long-term care insurance,
- Investment insurance, and
- Medical insurance (contingent upon the outcome of national health reform).

An interactive system, using the latest technology, will be used to obtain demographic, financial, health and other information. The system will then use this information to explain to applicants the implications of the primary risks they face, both at present and in the future. Next, customers will be provided with a menu of several possible insurance policies to choose from, with each policy offering protection from all the primary risks, but differing in cost and the amount of coverage provided. All the policies on the menu would be optimized, based on the applicant's risk tolerance and other variables, so that regardless of the policy selected it will provide the best possible coverage at the lowest possible cost. To achieve optimal protection, the coverages contained in each policy would be expressed in flexible terms. For example, the amount of life insurance would vary over time (possibly reaching zero coverage at some point) and correlate with specific factors such as income, family status, other assets and tax considerations.

For each policy being considered, the system will illustrate the impact on an applicant's projected future net income and net worth under a variety of scenarios. These scenarios would be designed to show prospective insureds that insuring for more risks (rather than fewer) and insuring for these risks sooner (rather than later) provide the maximum protection at the lowest cost. For example, the scenarios would demonstrate the advantages of funding long-term care throughout an entire lifetime, increasing the proportion of young insureds that currently have long-term care coverage. If this strategy is successful, it will provide a company the opportunity to expand the size and diversity of its risk pool, reducing the average cost of coverage for all consumers.

Even after the policy is issued, the risk management system will allow the insured to view updated illustrations as circumstances and risk tolerances change. The system would continuously monitor changes in the family's risk exposure and notify the insured of coverage adjustments that might be needed. Selected coverages could be modified at any time. The actual product details may vary from company to company, but the main objective is to enable individuals to fully understand the risks they face and provide an efficient and effective way to protect them from as much or as little of that risk as desired.

In order to create a risk management product for the individual and make sure it is financially sound, many issues must be addressed. First, companies need to dramatically improve existing enterprise risk management practices. Regulators, the public, and company management must all be confident that companies will be able to handle the additional risks they are accepting. Companies that are successful should benefit from a larger pool of offsetting and uncorrelated risks, providing a reduced net risk exposure and an improved ability to absorb future extreme unexpected events.

Pricing for morbidity and mortality risk can continue to rely on actuarial principles, but must go further by considering the combination and interaction of risks at the individual and family level. Pricing at this level will make coverage less expensive compared to insuring each risk individually with a separate product. In addition to pricing traditional risks in this new framework, actuaries and other insurance professionals must also evaluate and profitably

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price risks that are very prominent, but have not commonly been insured. Specifically, the risk of decline in retirement investments will need to be addressed with investment insurance using both existing and new techniques. This coverage might guarantee a minimum return over specified intervals, such as a 3 percent return on a stock mutual fund at the end of 20 years. Risk-based pricing would be used so that insuring riskier investments and having more generous guarantees would cost more.

Marketing must be modified to better educate the public about these risks that imperil the financial health of individuals and families. For this product to work, the public must understand it is more effective and less costly to address these risks at the household or individual level rather than in piecemeal fashion through a variety of separate policies. Underwriting must be flexible and timely, while avoiding anti-selection. By 2020, technology and electronic commerce will have advanced rapidly, and companies must fully utilize these new technologies in all aspects of the marketing and administration of this new product. Finally, the costs for improved risk management, pricing, underwriting, marketing and administration all must be kept low in order to provide greater insurance coverage at a lower cost.

Companies, regulators and other interested parties have all recognized the need for insurers to manage their own enterprise risk, but the industry now needs to focus its efforts on managing the risks of individual customers. As the leading experts on risk and insurance, actuaries must take the lead in promoting this concept to company management and employees as well as with regulators and the public. If companies can begin to demonstrate they are helping manage the risks faced by individuals and families in a comprehensive manner while remaining financially sound, the existing regulatory and other barriers to change will dissipate. A successful implementation of an individual risk management product will give the actuarial profession a great opportunity to fulfill its responsibility to the public and provide a solid foundation for a thriving life insurance sector of the future.

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