A New Perspective On Some Familiar Risks

by Steven Malerich

The life insurance sector of the future faces two significant societal risks that have so far been of little concern to the business. A financially sound, operationally efficient, growing and profitable company in the life insurance sector in the year 2020 will recognize these risks, will understand their significance to the business, and will act to lessen the risks while addressing customer needs in the face of the risks.

Although the coming demographic shift in the United States and several other nations has been well known for many years, some of its implications are not yet widely recognized. Beyond any issues of financing retirement needs is the issue of producing goods and services for the entire population. Despite the known concerns, there is a risk that too many people will retire too soon, leaving too few workers. If that does happen, we may not know it until it's too late to correct. One likely result is rapid inflation eroding the value of what retirement income most people will have.

Environmental risks are also well known, but again some implications are not widely recognized. Among the risks are climate change, depletion of energy and fresh water supplies, and strain on various food sources. Here, too, a risk is that supply will be unable to meet demand, and rapid inflation will erode the value of retirement income.

A true nightmare scenario could occur if both risks are realized—too many people retire too early and we see a collapse in productive capacity due to environmental degradation.

What These Mean To Life Insurance

To imagine a sound, efficient, growing and profitable life insurance company in 2020, we must understand what these risks mean to that company.

Demographic Risk

The relevance of the first risk—too many people retiring too soon—is easy to see. Thirty years ago, we saw rapid inflation and high interest rates. We have experience with some of the dangers they pose to life insurance.

Some have argued that demographics played a role in that period of economic turmoil, with a large generation of young people facing the capital needs of their new adult life. (I am among that group—see my editorial, "Thinking about the Unthinkable," in the March 2004 issue of *The Life Actuary.*)

Now, that same generation is moving into retirement. The new risk has some resemblance to the old, but the needs of our customers will be different.

In that past era we had some challenges keeping existing policies in force, but high interest rates allowed us to paint a very attractive picture of our new products. Selling more life insurance was an obvious approach to meeting customer needs. Growing incomes of the young generation made that possible.

This time, incomes will be declining. The challenge will be to sell adequate retirement income protection to those same customers while they still have enough money to buy it. If we fail to capture the money early, what's left will likely be insufficient by the time people realize they need the protection we offer. And, if inflation erodes the value of what protection we do provide, our customers will not have enough money left to buy more protection.

Environmental Risk

It's harder to see the relevance of the second risk—environmental degradation—to a life insurance company. Except for the obvious fact that the business needs people and resources, which are both threatened by these risks, we don't normally think of this as significant to our business. Yet, significant it may be.

The performance of our products, for the customer, may be inadequate if scarcity leads to rapid inflation, which then leads to a loss of purchasing power. A guaranteed lifetime income isn't of much value if inflation makes it insufficient for satisfying basic needs.

That either or both of these risks will be realized by 2020 seems unlikely, but by then one or both might be unavoidable. Adding to these societal risks, insurers will face a particular risk—reputation. Promises of a secure retirement income will ring hollow if that security is eroded by inflation. Regardless of what causes inflation, life insurers may be seen as failing to deliver on their promises if many customers see the value of their protection evaporate and they can't afford to buy more.

A Successful Life Insurance Company

A sound, efficient, growing and profitable life insurance company in 2020 will be actively involved both in minimizing the risks and in protecting its customers from their effects.

It is possible that the current financial crisis will mitigate these risks. Even coming out of the recession, consumption may stabilize at a lower level than before, slowing the environmental strains. And, capital markets may not come back as strongly as before, inducing more people to delay retirement.

It is also possible that we'll exit the current crisis much as we have done other recessions of recent decades—with ever-growing consumption and renewed optimism leading more people into early retirement.

The more conservative of these scenarios would likely make the following transition easier for life insurance companies. The more aggressive scenario would likely make the transition difficult. Either way, the path to success is essentially the same.

Investments

As a major source of capital, insurers have the opportunity to see the coming dangers and invest in promising solutions to the risks. This will require increased foresight. In contrast to the consumption-oriented economy the world has known for several decades, investing in ever-increasing production may be damaging, perhaps even fatal. Redirecting investments to long-term productivity needs will be difficult. It is easier to anticipate near-term benefits than long-term, but near-term anticipation will almost certainly fail to see major problems before they develop in the coming years.

Some insurers may try to anticipate the best solutions for the greatest dangers and invest accordingly. Among these, a few may guess right and reap the windfalls of being invested in the right businesses at the right time. Any such companies, and their leaders, will be seen as visionary and celebrated in the business and popular press. However, such a strategy would likely see far more companies guessing wrong and suffering because of it. This is a high risk strategy, and probably best avoided by most.

A sound strategy for facing these risks might be to begin early, in the next few years, investing relatively small amounts in various businesses or technologies that hold hope for preventing or mitigating the dangers we face. Gradually, more money can be invested in areas that remain promising. Especially if followed by many insurers, such investments may be all that's needed to develop solutions to some of these problems before they become acute.

Products

If numerous insurers are widely invested in solutions to the problems associated with these risks, we may avoid severe shortages and hyperinflation. However, there would remain a significant danger that the problems are not entirely avoided. Even more moderate levels of high inflation can be devastating to the value of financial security programs that do not include significant protection against inflation.

As before, a company can successfully serve life insurance needs even if inflation becomes significant again.

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Despite the new significance of a retired population, there will still be younger families for whom life insurance provides important protection. However, this time the young family market will not be a growth opportunity, except to keep up with inflation. To continue growing, the successful company will need to serve the needs of the growing retirement population.

Historically, life insurers have held a small share in the retirement income market. Social insurance and pensions have dominated, with individuals retaining the risk that their personal savings will be exhausted before they die. The successful, growing company in 2020 will have to tap this market. To remain successful, that company may have to provide substantial protection against inflation.

Reaching this market will not be easy. The associated dangers of not having guaranteed lifetime income and of any such income proving inadequate after inflation are both long-term dangers. Most people are not easily persuaded to sacrifice now for protection against such distant risks.

To make those sales, the insurance company will have to overcome inertia. To retain a solid reputation, the company will have to deliver on its promise of protection even under conditions of elevated inflation. And, if the company is to remain strong, the products will have to perform well for the company, too. Perhaps that takes us back to an investment strategy designed for the times.

Conclusion

In 2020, a life insurance company will be positioned for success by having made investments that enhance worker productivity to support a higher dependency ratio and that overcome many of the stresses now placed on our environment. Those investments will be complemented by products that protect the purchasing power of retirement income guarantees, as well as the longevity of those guarantees.

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