Keeping The Promise

by Dennis R. Barry

In order to imagine the outline of a successful U.S. life insurance company in the year 2020, it's important to think for a minute about what the world in which that company operates will be. There are a lot of possibilities for nearly every aspect of life in the United States, but one demographic fact above all others has potential to dominate the landscape. In 2020, almost half of the baby boomers will be on Medicare and nearly all will have reached an age at which retirement is either a current reality or a rapidly approaching one. The implications are many, and some are ominous:

- Pension plans, which for many, many years have been major buyers of stocks and other securities in this country, will be in or near liquidation status where investments will be sold rather than bought. The effect on the securities markets may be profound.
- Governments which have the responsibility of paying for the promises made in earlier, less demographically challenging times, will be cash-strapped, more so than today. State and local governments will face daunting problems relating to pensions and retiree health benefits for their workers, as will the federal government but with vastly differing means of financing the liabilities.
- The Social Security system in total, and Medicare specifically, will be facing severe financial problems.

All these issues will threaten the social contract under which we've operated for a long time. In that setting, with so much of life in flux for all generations, and with all of society entering rougher and more uncharted waters each year, the life insurance company that will be successful is one that can market, manage and deliver on guarantees. Making and keeping promises will separate the successes from those that don't last. This position is nothing new. Insurance has always been the vehicle that promised a result to its customers and delivered it. But along the way, we thought that in order to compete with other financial institutions we needed to look more like them and less like our traditional selves. The years 2020 and beyond should refocus both our customers and our companies on the value of meaningful long-term guarantees.

A successful guarantee business requires three distinct focuses as the business develops:

- Choosing which of life's risks to insure and how to do so,
- Managing the assets and liabilities until the guarantee comes due, and
- Making good on the promise.

The first of these focuses is essentially the marketing function. Insurance companies choose which business(es) to be in, find adequate capital to fund the business, and then develop and market products. Marketability will depend on finding a delivery system that can sell the promise at a price that is both attractive to the customer and sustainable for the insurer. There's nothing magic here. This is what insurance companies have done for well over 100 years. But in the past few years, guarantees have lost ground to the sexier market-based financial products that, because of their (sometimes) spectacular performances, made guarantees seem stodgy and unnecessary. Why go for a low-return guaranteed product when you can buy a market-value product that will greatly out-perform it over the long haul? Of course the answer is that in the short haul, which is where we actually live, things aren't always quite so rosy, but except in times of pronounced volatility people tend to forget that fact. The demographics of the third decade of this century look likely to have a negative effect on stability in a lot of things.

The second focus, managing the promise, is fraught with difficulties relating to risk management. There are obvious financial issues. How best to fund a particular promise—the old fashioned way, via conservative investments that over time bring the desired yield and preservation of capital, or via hedging and other financial strategies that rely in part for their success on the financial stability

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of a variety of counterparties? Or perhaps it is a mix of the two, or an approach that has not yet been used for these types of products. The financial approach to products offering meaningful guarantees will require decisions that are complex, difficult and very important. Beyond the financial aspects of guaranteed products, how sure are we that the promise itself won't change over time? For life insurance, it used to be that dead was dead. Now medical technology can keep alive someone who a few years ago would already have come to the end of life. A simple promise to pay at death has become somewhat fuzzy. Other forms of guarantees have similar risks. A court decision that changes the meaning of a well-established provision of a long-term care policy could wreak havoc on that line of business overnight. The same goes for critical illness policies, disability and many others. Only payout annuities seem somewhat secure, but as mentioned above, medical technology can affect longevity, in both directions. The bottom line is that, except for the very simplest forms of insurance, it isn't certain that the promise assumed at the beginning of an insurance policy is what will eventually have to be delivered.

Which brings us to the final focus: delivering on the promise. The simple "you die, we pay" premise of a life insurance policy reflects the ultimate delivery on this contract. Along the way, a lot of things may have happened to both parties to the deal but at the death of the insured, the insurer must pay. For other forms of insurance, and their guarantees, things are not so simple. As noted above, a court decision can undo many years of practice in a particular line of business. Think of the potential legal risks inherent in a long-term care policy where any or all of the activities of daily living can be redefined by a court at any time or where changes in methods of treatment can radically change what long-term care means. Consider the effects of the current economy on disability coverages. Or what will happen to lifetime income guarantees if life expectancy takes a leap because of medical advances involving bionic parts and transplants that are unthinkable today? Being in the guarantee business means that no matter what happens, for better or worse, the insurer must deliver on the promise when the time comes, even if the promise has changed in the meantime. Making that come true will require that premiums, reserves and insurance company capital levels be realistically conservative and not just optimistically adequate. The guarantor is going to have to be able to survive the thousand-year rain, even if it occurs twice in five years.

Guarantees are what set insurance companies apart from other financial institutions. In the insurance world, however, life insurance companies are unique in the length of time over which their guarantees may apply. A life insurance policy, issued on a newborn in 2020, could well be in force in 2120, and if there are settlement options available, it could still be delivering on a guarantee many years into the 22nd century. That uniqueness offers insurers an opportunity to fill a product/marketing gap that no one else can fill, but it also requires the discipline to recognize that this different financial role carries with it different management responsibilities. Selling guarantees must ultimately be secondary to delivering on guarantees.

Life insurance companies may have to compete with other financial institutions in the capital markets, but doing so cannot be at the cost of abandoning their unique ability to offer the guarantees that no one else can. Guaranteed products can be priced for returns that are competitive with other financial products, but it may take longer for them to bear fruit. Guarantees that last 25 or 50 or 100 years do not lend themselves to a management style that focuses on quarterly earnings. It isn't realistic, and it isn't prudent. If insurers take advantage of their unique market, and manage their products and businesses appropriately, the rewards will be there, eventually, for all stakeholders. But if for the capital markets, "eventually" isn't satisfactory, then it may be that the surviving, successful promise sellers of 2020 and beyond will be the remaining large mutual life insurance companies who can, if they stick to the markets

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they know best, generate the capital they need on their own.

Life insurance, like all businesses, offers unique opportunities and challenges to the companies manufacturing and marketing those products. Like other businesses, success will come to those that take advantage of their opportunities and deal most successfully with their challenges. Time will tell, but betting on the success of life insurance companies whose marketing and management focus is on the guarantees that are unique to their charter seems like a good choice.

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