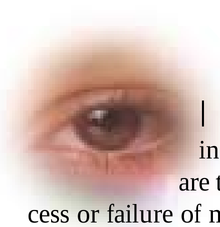
By Kenneth W. Faig

Crystal Gazing

THINKING ABOUT LIFE INSURANCE IN 2050

A life insurance veteran speculates on life insurance in cyberspace, where virtual insurance companies will be transacting mega deals and the underwriting process will take place in the blink of an eye. Or almost.



I STARTED TO WORK in the life insurance industry several years before 1975, so the odds are that I won't be around to account for the success or failure of my predictions when we reach 2050. But it's fun to think about where the next 50 years might take us. Basically, I believe that the human family will survive as an institution and that government won't provide cradle-to-grave economic security for families. In other words, I'm assuming that the basic need to provide economic security for surviving family members is going to persist.

The Structure of the Industry

One of the brightest colleagues I ever encountered in my years as an actuary had a vision of the "virtual" life insurance company of the future. In his vision, virtual life insurers would employ very few people apart from a small dedicated staff of what he called financial architects.

The dominant companies would control huge blocks of business but would contract out virtually all the ministerial functions of the business—issue and underwriting, policy administration, claim administration, and record retention. It's not inconceivable that other functions—including investment portfolio management, valuation, product development, distribution, and litigation management—could also be contracted out. I think cash flow projection and experience analysis are likely to remain with the insurance company itself.

Who would be employed by the risk-bearing entity itself? In my colleague's vision, the core of the enterprise would be an elite staff of financial architects who would assemble and analyze underwriting results. The CEO would have responsibility for strategic planning, including mergers and acquisitions, and stockholder relations.

Designated staff members would manage the third-party relationships for each of the outsourced functions. Proper management of the third-party contractors would include not only quality control but also results-benchmarked compensation structures. The underwriting contractor, for example, would surely be compensated in part based upon mortality results.

Consisting as it will of a small number of highly skilled and highly compensated professionals, virtual life insurance companies will free themselves from the costs and complications of maintaining a large labor force. The great majority of the human resource-related costs formerly borne by the company will now be borne by its outside contractors.

A doomsday scenario for professionals in the life insurance business? I don't think so. My colleague's vision is likely to result in greater prosperity and visibility for all the professions that serve the life insurance business, particularly for those entrepreneurs who found their own firms. Working for such a professional service firm won't liberate professional employees from the inevitable demands and conflicts of the work environment, but it will ensure that their own professional discipline is the key driver of their employer's success.

My own prediction is that many of the professionals who

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currently serve the life insurance industry will find greater opportunity for professional advancement and fulfillment in a service firm environment.

For many life insurance companies, outsourcing the majority of functions would represent a tremendous cultural change. Many companies, perhaps even a majority, will elect to retain their own professional staffs and to compete on this basis. Of these, quite a few will continue to be spectacularly successful doing business their way. They will, of course, have to compete with the virtual companies whose every third-party relationship will be both cost- and results-driven.

The best-managed and -focused do-it-yourself companies will likely compete very handsomely against the virtual companies. But without a specific market niche, less-efficient do-it-yourselfers will probably have difficulty surviving to the year 2050.

Insurance Regulation and Taxation

Will we see the emergence of a completely free global market for life insurance with minimal regulatory constraints in the next 50 years? A world of pure caveat emptor transactions for the buyer of our financial security products? I don't think such a vision is impossible, but it depends on strong professional standards and discipline for all the professions serving the life insurance business.

In a world where any business entity can promise future performance for current consideration, the ability to meet contractual promises will be crucial. With strong global professional standards for all of the professions serving the life insurance industry, I think a totally free market could work. Such an environment would inevitably generate a secondary market for third-

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party "performance" guarantees. If I insure my life for $1 million with Company A in a free market environment, I may very well proceed as a matter of course to purchase a guarantee of Company A's performance from Company B.

My own expectation is that governmental regulation of the life insurance business will not disappear within a 50-year horizon. But as the business continues to globalize, we may see a greater choice of venues for insurance consumers. In the United States, it's entirely possible that future insurance regulation will have both federal and state tracks. The nature of the regulation that might emerge under alternative regulatory tracks is more difficult to imagine.

One can imagine a federal regulatory structure with a great deal of rigidity within each line of business, with heavily regulated contractual terms and premium rates. Such a rigid federal track would doubtless be in nearly continuous conflict with a more free-wheeling state track.

On the other hand, a much more open, file-and-use federal track—unburdened with the extensive history of state insurance regulation—could become a very attractive venue for many life insurance companies, especially larger companies that want to conduct business on a uniform basis nationwide. The relative security of the two regulatory systems would doubtless become a consumer issue. The state guarantee fund safety net would be a strong playing card against a caveat emptor federal regulatory system.

Will insurance customers of 2050 be able to buy life insurance from any company in the world willing to insure them? If I'm a citizen of Country A, will I be allowed to purchase life insurance from a company domiciled in Country B? If so, will I have to abide by the rules of Country B? I think the answer will rely on intergovernmental pacts and the strength of the professions that serve the life insurance business globally.

It's nearly impossible to predict the future of the taxation of the life insurance industry and its products. I think taxes on companies will depend heavily on governmental financing needs; there may be a trend toward a level playing field for corporate taxes on all financial service businesses. The life insurance contract, however, is likely to continue to enjoy significant tax advantages at the policyowner level. I don't foresee the repeal of the death benefit exemption of IRC 101(a) in the United States within the foreseeable future.

The survival of the tax deferral of the inside buildup of life insurance in the United States is a closer call. There will undoubtedly be pressure for change from manufacturers of competing financial service products that don't enjoy tax deferral. I believe that the emergence of combination products that bundle life, accident and health, and even property and casualty risk may make some policyowner-level taxation decisions more complex.

Distribution Systems

I grew up with the agency system of life insurance distribution. At the first company where I worked, the president had a rule: The semimonthly commission cycle ran before the semimonthly payroll cycle. If the commission cycle didn't get run, the employees didn't get paid. The producers were perceived as the lifeblood of the business.

But I find the perceptions of my colleagues in the life insurance business changing. Management in many life insurance companies evinces concern about the high cost of traditional distribution systems and wants to explore alternatives. Many of the young computer-literate people I know don't want to share their financial needs and objectives with an outside party.

These young computer literates consider the involvement of an agent in the purchase of life insurance an added cost rather than an added service. I disagree. If I had always heeded the advice of the life insurance agents with whom I've done business, I'd probably have a better, less costly life insurance portfolio today. In particular, I regret deciding to surrender some of the permanent insurance I once owned; I find myself paying increasing premiums for a term life insurance portfolio I can no longer afford to convert to permanent insurance. And I'm supposed to know something about life insurance!

Many of the young computer literates I know would rather purchase insurance on the Internet in the privacy of their own homes. They can already do so for automobile insurance and other personal P&C lines. With the approval of electronic signature legislation at the federal level, I am convinced they will be able to purchase life insurance on-line within five years.

Of course, potential on-line buyers of life insurance will find a plethora of competing sites:

- Insurance companies selling direct to the public
- Insurance company agents
- Marketing firms selling on a commissioned basis (e.g., brokers)
- Marketing firms selling on a fee-for-service basis (e.g., financial planners)
- Regulatory information and product/company comparison sites
- Third-party information and product/company comparison sites.

For the general public, it may not necessarily be easy to distinguish one type of site from another. Because some consumers will still want a guide through the forest, I think insurance representatives of various kinds will continue to play a strong role in the life insurance distribution system in 2050. I foresee a particular opportunity for local businesses with a strong community identity to serve consumers who remain hesitant about electronic insurance purchases.

Though there will undoubtedly be nationwide franchises seeking local representation, I think strong local identification and multiline capacity will be significant potential advantages for local businesses that want to serve these insurance consumers. Having “ABC Insurance Agency” on the jerseys of a local sports team, for instance, will continue to have real economic value in the life insurance business. I suspect it will continue to take a lot of Internet “hits” to produce the same economic benefit as a local sports team sponsorship or other generally recognized forms of community service.

Name recognition will surely count for much at the local, national, and international levels. The companies that will be successful in selling life insurance through the Internet are yet to be determined. I anticipate that companies with strong name identification may be among the Internet success stories even if they are relatively late entrants into the dot.com fray.

How We Transact Business

I think paper will largely go by the wayside. We may still have a paper contract option for consumers who don’t want electronic contracts, but we’ll certainly transact almost all of our business electronically including the business originated in local insurance offices.

Electronic signature legislation will facilitate electronic applications, and security systems will protect the integrity of these applications and the resulting policies. The real question is how we get from application to completed contract. This step will be the major frustration for potential Internet life insurance purchasers who expect nearly instantaneous results.

I believe the underwriting time barrier will be broken well before 2050, perhaps even within the next five to 10 years. Underwriting standards differ from company to company, but there are usually a set of core requirements that apply across the great majority of companies. What if many of the companies in the life insurance industry were to agree upon a common format for an electronic underwriting file (EUF)?

I can foresee the development of service organizations whose specialty would be the manufacture of EUFs. The EUF manufacturer could verify the identity of the proposed insured and perform or arrange for medical tests whose results would be posted to the EUF. With the authorization of the proposed insured, the EUF manufacturer could add to the EUF items such as attending physician’s statements, motor vehicle reports, inspection reports, and FIT returns, all in standardized electronic form.

An EUF could remain open for a limited period of time (e.g., three months) upon completion and accessed by all potential insurers to whom the proposed insured applied. EUF security would doubtless be a strong concern, but I believe the necessary protection can be achieved.

How would the EUF manufacturer be compensated? All the life insurance companies that accessed the completed EUF during its open period on the basis of applications received from the proposed insured would share the cost of assembling the EUF. If a company asked for additional information not included in the EUF “core underwriting profile,” that company would bear the cost of assembling the additional information. In the interest of fairness, it’s possible that such additional information could be denied to other companies unless they agreed to share the cost. Like all outside contractors, EUF manufacturers would be rewarded based on the timeliness and quality of their work.

Inevitably, some life insurance companies would resist contracting with EUF manufacturers. Companies with very strong control of their distribution mechanisms might try to distinguish themselves with contract nuances such as the elimination of suicide exclusion and contestable periods from their contracts. Companies relying on third-party EUF manufacturers will doubtless be more reluctant to remove such contractual defenses from the protection of their underwriting results.

In short, competition to shorten and simplify the underwriting process, while maintaining its integrity, is likely to produce contract nuances more favorable to the consumer. Some companies may even grant a limited amount of true temporary insurance while the underwriting process takes place. These companies would have to price on the expectation that they would keep the initially tendered premiums for temporary insurance claims and for completed policies, but lose them for any forms of declination, counter-offer, or not-taken.

Particularly in the market for larger-sized policies, we'll probably see marketing specialists who will undertake to place a specified amount of insurance in force on the most favorable terms once the EUF is complete. The marketing specialist may decide to place the insurance portfolio in Companies A, B, C, D, and E, all of whose underwriters will receive the completed EUF and electronic applications. (The standardization of electronic applications themselves is another area where life insurance industry organizations could make strong progress.) If markets permitted, the specialist might even attempt to get all the potential insurers to agree on a single price. In any case, I anticipate that the availability of EUFs will greatly facilitate the management of large, complex insurance portfolios.

The life insurance industry will undoubtedly need to take steps to protect itself against unwanted "blast" electronic applications with little or no chance of policies placed in force. One strategy would be to consider only applications accompanied by an initial electronic premium payment covering a defined minimum period.

It'll be important, too, to coordinate acceptances so that inappropriately large amounts of life insurance aren't placed in force on the basis of a single EUF. Perhaps life insurance companies using EUFs will be required to register their underwriting actions in the EUF itself. Electronically placed coverage might be subject to a predefined total maximum acceptance level and subject to rescission if the limit is exceeded. Some companies might even consider a cancellation charge for not-taken policies if "free look" requirements could be amended to allow such a charge. Declinations and counter-offers of altered coverage would undoubtedly have to continue to be accompanied by a full premium refund.

The reinsurance industry will undoubtedly play a significant role in defining necessary protections for electronically transacted life insurance. The binding and jumbo limits defined in existing reinsurance treaties will certainly play a strong role in the early development of Internet life insurance sales. I suspect most life insurance companies will require the collection of tax identification numbers at application for all proposed parties to a life insurance contract for electronically transacted business. This requirement will protect against fraud, including identity theft.

That some companies will end up insuring phantom insureds seems almost inevitable once life insurance can be transacted in cyberspace. I think companies will find that requiring a face-to-face meeting between the proposed insured and an EUF manufacturer, at least for larger face amounts, will provide a significant protection against paying phantom claims. In the United States, death records are open public records in most states, and the death record of an early decedent with an appropriate date of birth can readily provide the basis for an identity theft.

Final Reflections

I think the future holds great opportunity for the life insurance industry and the professions that serve it. Change will threaten our viability only if we as an industry refuse to accept change. I believe the need for family-based financial security products will still be very strong in 2050. (At least I hope so, for the sake of my grandchildren.) I believe the life insurance industry of 50 years hence will offer more choice, more protection, better prices, better service, and better privacy protection than the industry of today.

I believe that governmental regulation of the life insurance business will still be around in 50 years. It'll focus on economic viability and professional practices. Taxation will still be around, too, and will recognize the necessity for equity among competing financial vehicles and their manufacturers.

I expect, however, that life insurance death benefit proceeds will continue to enjoy tax exemption from federal income tax in the United States. Taxation changes at large (e.g., elimination or alteration of the federal estate tax) may affect the types and amounts of life insurance purchased. I expect that the next 50 years will witness less emphasis on the tax leverage of the life insurance product and more emphasis on the basic social needs it serves.

The professionals who serve the life insurance industry will remain its greatest strength. Far more of them will work for service and consulting firms managed by members of their own professions, rather than directly for insurance companies.

The professionals serving the life insurance industry (whose senior members are probably just now being born) will enjoy greater visibility and prosperity in 50 years than they do today. With their enhanced visibility and prosperity, however, will come greater public accountability for their actions.

The long-term beneficiary of the changes the life insurance business will experience in the next 50 years, however, will be the consumer. Change that doesn't benefit the consumer will, in the long run, prove counterproductive.

By purchasing the financial security products our industry offers, the consumer voluntarily elects to sacrifice current consumption for future protection. The life insurance industry in the United States has spent a century and a half building public trust and fostering employee professionalism. All that progress, however, will prove worthless if the family life that motivates the life insurance transaction disappears.

That would be the worst future of all. ●

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