Case study - Risk Individualisation in UK Life Insurance - by Arjen van der Heide

Individualisation refers to a process in which the uncertainty around insurers' investment returns is increasingly located at the level of the individual. The financial uncertainty that comes with long-term insurance promises is increasingly owned by individual policyholders, not insurance companies.

The policyholder benefits of long-term life insurance products are increasingly tied directly to financial market performance, which is reflected in the shift from so-called with-profits insurance schemes towards unit-linked schemes. Wherever life insurers provide financial guarantees, individual policyholders are charged for the cost of capital needed to cover the risk of those guarantees.

Individualisation of risk was the outcome of a challenge to the dominant position of conventional insurance companies by newly founded 'unit-linked' insurance companies.

Changes to key elements of the insurance approach

In traditional life insurance, uncertainty was dealt with through (1) discretionary bonus distributions, which allowed for the redistribution of benefits between more fortunate and less fortunate generations of policyholders and (2) actuarial prudence - calculating the premiums needed to provide long-term insurance protection in such a way that the expected outflow of resources would be lower than the expected income with reasonable certainty.

In the contemporary structure, in contrast, uncertainty is transformed into a risk commodity owned by individual policyholders. This is done through:

(1) 'market-consistent' valuation, which seeks to calculate what the economic value of insurance liabilities would be if they could be traded in secondary markets. Since this is not possible, financial models are used to infer this value from the market value of a 'replicating portfolio' of financial instruments with closely matched characteristics to the liabilities.

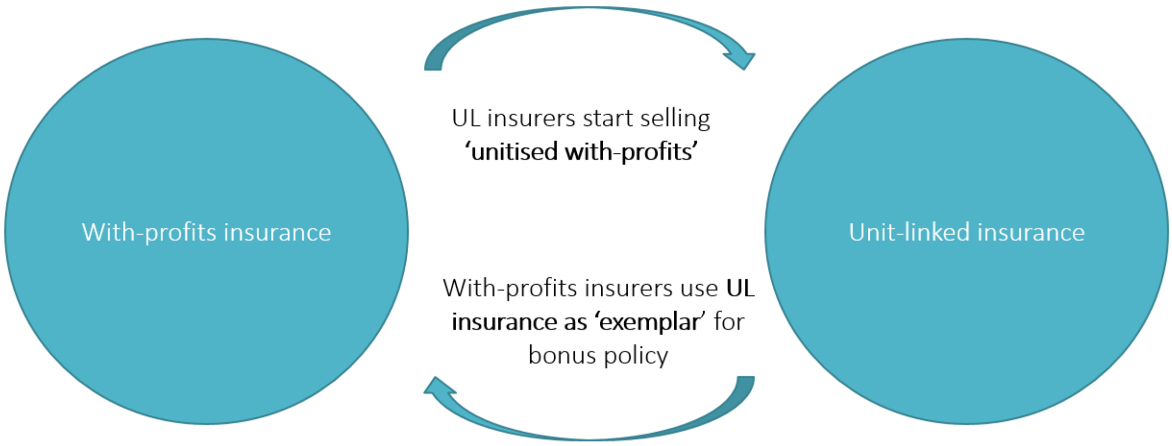
(2) 'risk-based capital' calculation, which involves developing plausible future scenarios for a variety of 'non-diversifiable' risks, such as equity risk (the risk of a large drop in the value of equity investments) or 'longevity trend' risk (the risk that improvements in the life expectancy of policyholders exceed actuarial assumptions).

How did the process happen?

1. To address uncertainty about insurance companies' ability to meet their future obligations, actuarial valuations of insurers' long-term liabilities included margins. These were intended to make sure that the premiums they charged their policyholders were on the 'safe side of things'.

2. The emergence of unit-linked insurance companies posed a challenge to traditional with-profits insurers. Unit-linked insurance used a strategy that was previously impractical due to the high administrative cost in an era with limited computational technology. From the late 1960s onwards, the life insurance market saw many new entrants.

3. Competition between incumbent with-profits insurers and challenger unit-linked insurers led to the hybridisation of the two types of arrangement ... the hybrid insurance structures that became increasingly widespread in the 1980s combined elements of both conventional with-profits arrangements and unit-linked insurance.



4. This hybridisation led to confusion about how insurers were to deal with long-term financial uncertainty, which contributed to the downfall of one insurance company in particular: Equitable Life.

5. The collapse of Equitable Life led regulators to take up a more active role in the governance of life insurance. They imposed new techniques of quantification in the early 2000s that ultimately solidified the core features of contemporary insurance arrangements.