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## LIFE, FAMILY, AND THE PURSUIT OF RETIREMENT



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## **Life, Family, and the Pursuit of Retirement**

### **Abstract**

Insurance companies present themselves to the public as institutions providing *protection*. But of course, they do not really protect from the insured events, such as hurricanes, or car accidents, or death. No matter how sophisticated and advanced the work of an insurance firm is, no insurance company can prevent any of those. Instead, insurance companies provide financial compensation for losses due to the insured events. The result is that, on a social scale, insurance industry provides encouragement for risk taking, not protection. In this work, we analyze this perspective on the business of life insurance and life annuity.

## **The object of life?**

“The only object of liberty is life,” said G.K. Chesterton. But then what is the object of life? Life insurance, that is: In its standard death protection form, and in the retirement or disability annuity form. There is, of course, that key word used in description of insurance business: *protection*. I have for a while now argued against it being presented as the purpose of insurance. Protection can be perceived as the purpose of insurance from the perspective of an individual policyholder. But even from that perspective, insurance companies cannot really protect from hurricanes or heart attacks – despite our best efforts, we cannot stop those. I do admit that insurance companies can make a contribution to building homes that better withstand hurricanes, and to provide education and incentives for consumers to improve their cardiorespiratory fitness. But no knight in shining armor will run to the rescue of the customer, instead the best the customer can expect is just a wise actuary with proper price of risk, and suggestions on how to manage that risk. I dream of the day when an actuary can, with his mind and predictive analytics, stop a hurricane in its tracks. But this will remain a dream, at least for a while.

If not protection, then what? Risk taking, of course. While the individual perspective may suggest the purpose of insurance is “protection”, the social purpose of insurance is to help our customers take on more risks. Without car insurance, we would be driving less – it is car insurance that causes us to drive more, and that is indeed a risky activity. Without homeowners insurance, we would not build homes on the beaches of Florida or Alabama, as we did not in the nineteenth century, when homeowners insurance was not widely available.

In the context of life insurance, we often say that life insurance provides protection against death that comes too early, and life annuity provides protection against death that comes too late (not that an earlier death would be welcome news, but death does end financial worries). That is, of course, the individual perspective, emphasizing protection. But even at the individual level, this perspective is incomplete. Because the object of life insurance (and life annuity) from the individual perspective is protection of two entities: Human capital and the loved ones. Or, to put it more simply: Work and family. Work and family are central to our lives, and the business of life insurance and life annuity offers not just protection, but a better fit between work and family. This is in fact its central purpose from the individual perspective. Protections in life insurance and life annuity are against events that are inevitable (death and leaving the work force), and it is only their timing that causes unexpected risks. If our human capital provided a perfect cash flow match for the needs of sustaining our own lives and the lives of our loved ones, life insurance would have no reason for its existence. In reality, of course, there is no such perfect cash flow match, far from it. Most financial worries, concerns about having a family, financial uncertainty that human beings face, are the result of the mismatch of the income one’s human capital provides and the cash outflows one has for the needs of oneself and the loved ones. This is why life insurance and life annuity products are effectively derivative securities built on human capital. Life insurance companies take the cash flows from human capital (yes, they are called premiums, but as our customers like to remind us, they reduce their disposable income) and turn them into cash flows that address the risk of death coming too early, or death coming too late, or leaving the labor force in an ill-timed fashion.

Both work and family are central in this equation. Work of the customer provides the cash flows for our business of life insurance and life annuity. But those work cash flows are risky, because of many factors, both individual and societal, that affect them. The obvious one is the risk of death, but there is also the risk of disability, risk of unemployment, risk of dramatic macroeconomic shifts causing underemployment or the need to change employment in a

significant fashion. To the greatest extent possible, life insurance and life annuity providers should seek to manage those risks with their customers. But family is the reason why those cash flows need to be managed, and it is the family context that gives us a full picture of how the cash flows from human capital should be restructured into insurance products.

In many areas of insurance, increased role of data science has resulted in better match of insurance products to individual consumer's profile. Not so much in life insurance yet. One has to wonder whether increasingly personalized products are possible in life insurance. Prying into personal health data and genetic make-up of customers is not viewed as consumer-friendly behavior. But we should also ask: If having extensive health and genetic data on a consumer and consumer's family allows the insurer to design products that dramatically better match the cash flows that the consumer and consumer's family will need in the future by the insurance products, could such transactions, if they remain appropriately confidential from other prying eyes, actually end up benefiting the consumers? Life insurance and life annuity products are, generally speaking, not individualized. But the nature of the product is very individual, personal actually, for the consumer. From the individual perspective, more personalized life insurance may become over time more feasible with new technologies, and more desirable for our customers.

### **Let's get risky!**

However, from the societal perspective, the purpose of insurance is not protection. Instead, it is *increased risk taking*. As noted before, car insurance results in more driving, homeowners insurance results in more homes being built, and often in more risky locations, and business insurance results in more business, and risky one at that, being undertaken. When those additional risky activities are insured and insurance is priced properly, the process is directed towards more rational and more productive activities. This is one of the key roles of an actuary – to price the risks so that rational and profitable risk taking takes place, while risk taking for the fun of it, or making no economic sense, or resulting in losses that far exceed the costs that could be borne to cover them, are rejected, priced out of the market. This may not give actuaries the top spot in any popularity contest, but it is the proper “adult in the room” role that the actuarial profession plays.

In the context of life annuities and retirement business in general, it is clear that the additional risk-taking insurance encourages is: Leaving the labor force. And again, we note that the full context of this risk must include both work and family. Leaving the work force is risky for two reasons. In the short run, the main risk is the loss of income. But in the long run, the main risk is the loss of ability to earn income, i.e., the loss of human capital. If the absence in the labor force becomes extensive, one may never be able to return to the labor force and replace the lost income with the new income. This is why the process of planning of retirement is so crucial, and why market pricing of the cost of retirement offered by private insurance companies (as opposed to public schemes, which tend to underprice that cost, and encourage premature departure from the labor force) is so essential. Leaving the labor force is not just a work decision. It is also a decision that affects one's loved ones. In other words, it is also a family decision. Thus, leaving the labor force makes sense only when at least a portion of the human capital that we are losing by making that decision, is replaced by our loved one's own human or financial capital. For example, we can retire more easily when our children, who used to be our dependents, no longer are such dependents, and instead they earn income to sustain themselves and, hopefully, their families.

Life insurance is often perceived as something of an opposite to life annuity. An insurance firm pays their life annuity customers as long as they live, and it pays the heirs or the estate of their life insurance customer, when the customer dies. Let us note also that in terms of incentives for additional risk taking that life insurance provides, it is also the opposite of life annuity. Life insurance is helpful in engaging in active, vigorous, and often risky professional activities in pursuit of one's career, while simultaneously having a family. Life annuity in the payout status says: "You can rest now" to the customer, but life insurance says loudly: "Get a job!".

Of course life insurance can, and very often is, purchased for other reasons. Especially one reason: As I always tell my students, when you see people doing really strange things with their money, the reason is always *taxes*. Nevertheless, in the world without taxes, life insurance and life annuity business is always about work and family.

### **Work and family: This is what we are all about**

Life insurance and life annuity industry exists to allow our customers to be more engaged and more daring, to take on more risk in two key areas of their lives: Work and family. This means that we are at the centers of our customers lives, even if only in the background of that center. We play an important role in the most important, and often most intimate and precious parts of their lives. With the growth and success of very competitive term life insurance and immediate annuity markets, it might seem that we are offering commodity-like products. But, properly viewed, insurance is never just a product. It is always a rearrangement of property rights, with customers ceding to us some portions of their contingent negative cash flows in return for paying us premiums. In the context of life insurance, life annuity and retirement business, such rearrangement is a restructuring of their human capital cash flows, allowing them to better manage the risks of their work and family.

And, importantly, we provide our customers with incentives for additional risk taking: To work and pursue career success at the time when they have significant family obligations, and to not work when they are ready for it. We do not just sell products. We help balance work and family, not as a mere slogan, but as a hard and real financial responsibility. It is a noble mission.

### **References**

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