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MARKETING DISTRIBUTION SYSTEMS

Moderator: WALT J. WOJCIK. Panelists: ROBERT D. HOGUE, JAY M. JAFFE, SANFORD W. SCOTT

1. Alternate marketing styles and inherent compensation methods - present and future.

    a. Career agent
    b. PPGA
    c. Direct Mail
    d. Over-the-counter
    e. Multi-line broker

2. Marketing profitability from perspective of the company, sales manager and producer.

MR. WALT J. WOJCIK: The purpose of this discussion is to cover the problems and opportunities facing the insurance industry in the coming years. The approach we are going to take this morning is a case study approach. We can begin by picturing ourselves listening in on a meeting in the offices of the ABC Life Insurance Company.

ABC Life is a fairly old company that has licenses in about 40 states and just over $100 million in assets and $20 million in capital and surplus. The company has been growing slowly using "traditional methods". The president of ABC Life is now asking what is the best course of action for his organization to follow in the coming years: should they continue along current lines or go into other areas?

To consider the possibilities, the president has recruited a group of acturial consultants to look over the company and to offer their recommendations as to a possible future course. These consultants were asked to comment on the following points:

1. A description of the possible marketing distribution systems for ABC to follow .

2. The necessary investment to enter the various markets.

3. The potential profitability of the different marketing distribution systems.

MR. ROBERT D. HOGUE: I will make the following assumptions:

1. The company is financially healthy, and that of their $20 million of surplus the president is willing to allocate $10 million for future development.

2. ABC Life operates under a career agent distribution system.

3. It has a stable and competent management team, but they are currently somewhat lethargic.

4. The president wants faster, but profitable, growth for the company. He has no major problems to solve, and he's considering no changes in the company's basic business mission.

Before reacting to the possible future sources of action that the company could reasonably consider, let me offer a description of the external environmental influences that will affect the company during the foreseeable future. ABC Life will not be in a position to be a leader in the insurance industry, but it must react to what the leaders do. Its future scenario will be a combination of the general business climate and the marketing influences of the larger companies operating in its principal marketing areas.

Four trend areas will have an impact on the company. The first is demographic trends. The major demographic trend which will affect ABC Life will be the loss of a growing market due to the lower overall growth rates in the general population. There will, however, be temporary high growth in the insurance buyer group, ages 20-35. A possible offset to this trend is the expected increase in longevity of the general population. The net result of these two trends will be a decreasing market for life but increasing market for annuity products.

The second is consumer's attitudes. The consumer's attitude towards the insurance industry will manifest itself in three key ways. The first is increasing service expectations. The consumer will continue to desire to deal on a face-to-face basis with an insurance agent who can meet his service needs. The second is the psychology of entitlement, which will create continued demands for social insurance and employer-provided insurance. This trend will effect a further declining market for insurance products which fulfill basic survival needs. The third is the educated consumer. In particular, he will have a greater desire for a personal financial planning program. This trend would indicate a growing desire for estate accumulation and possibly for life style protection insurance programs.

The third trend area to impact ABC Life is the marketing environment. There will be a growing market-share dominance by the all-lines insurance companies and insurance company groups. There will be continued diversification to the "full financial services" concepts in new product development. These trends will continue to split the basic permanent whole life insurance product into its term and investment elements. The life insurance industry will then be further split into two different but related businesses, the insurance business and the investment services business. This trend will serve to put continuing pressure on ABC Life's traditional products, and on its writing agent's capabilities.

The fourth trend area is the economy itself. The over-riding economic influence on ABC Life will be the continuing high expected levels of inflation. Its principal impact will be increasing marketing and operating expense levels without significant off-setting increases in investment income levels. Even though inflation is seen as a source of sales growth, though not a source of growth in terms of real dollars, a second major effect of inflation will be an increasing buyer demand for term insurance. This will put added pressures on the ABC Life's traditional permanent insurance product lines.

ABC Life's capabilities for reacting to the future demands and opportunities are existent but limited. The company's major strength is its financial condition and the existence of growth capital. The existing field force should also be considered a strength to be used as a basis of future growth. The principal company weaknesses are the existence of a lethargic management team and the limited financial and personal resources available for the enactment of major changes.

As the president considers change, he should concentrate on the major problems which affect the company at the present time and during the foreseeable future, and he should capitalize on the opportunities which are currently available to the company. The president's decision should be based upon several major problems and opportunities.

The first problem is the increased competition for market, which is the result of a lesser increase in the total market for life insurance, consumerists' demands for social and group insurance, and the influence of the multi-line companies and company groups in the market place. The second problem is the pressures on ABC Life's traditional life insurance products, primarily derived from competitive term insurance, competitor companies' investment products, and the expected emerging influences of life cycle policies. The third problem is the pressures on ABC Life's profitability which will be due to rising expense levels due to inflation, the pressures on ABC Life's gross premium rates due to influences of competitor companies, and the expected continuing high cost of career agent development.

The opportunities which the ABC Life currently has are as follows. The first is capacity - ABC Life is assumed to have $10 million for company development. Second, the rising consumer demands. In particular, the consumer's continuing desire for financial planning capabilities and his preference for dealing on a person-to-person basis with a life insurance agent. The third opportunity is change. The increasing rate of change in society will create demands for new products and will open new markets for the insurance industry. Any company which is oriented toward rapid change will have an edge during the upcoming years. The fourth opportunity is ABC Life's relatively small size. If properly structured, a small company will have a much shorter reaction time to new opportunities than would a larger and more bureaucratic organization.

In order to achieve increased rates of growth and long term profitability, ABC Life can reasonably consider changes in three primary areas: distribution systems, target markets, and current product lines.

Since ABC Life is currently a career agent company, its options are either to build upon that operation, to expand it to include brokerage or possibly PPGA outlets, or to enter on a program of mass marketing. Let's look at what's involved in each of these options.

For expansion of the current career agency system, the primary target markets for the company would be their current buyers. It would be possible to expand their marketing scope without great expense or effort. The ABC Life would maintain their current product lines which have seemingly been profitable. It would seem reasonable that the company would want to enhance its product lines in line with the changing consumer demands. If ABC Life maintains its current agency distribution system, then the growth path open to the company would be that of agency expansion. It would probably want to consider alternatives to its current agency structure. If, for example, it is under the general agency system, then it may want to consider the use of a sales corporation or the transition from a general agency to a salaried manager structure. In any event, it would have to develop a plan for either increasing the size and scope of its current agencies, or a realistic plan for the development of new agencies.

It is expensive to expand the company's agency system. The creation of new agencies, as well as the recruiting and training of new agents, would prove to be a significant drain on the company's surplus if it were to expand at a rate larger than the normal expansion rate of the past. The inherent risk in this growth strategy is reasonable. The primary risk is the possible higher than expected investment in agency expansion. However, it is always easier and safer to build on an existing operation than it is to initiate a new one. Due to the high initial expenses of agency expansion, ABC Life should expect short term losses. However, the expected long term profitability of this alternative is the highest of the available options. Since the ABC Life can control the allocation of the initial investment, and since it is reasonably familiar with both the career agent distribution system and the quality of business which that distribution generates, then it should be able to accurately predict the long range return on its investment.

For expansion of the current operation to include brokerage outlets, the primary target markets are not the buyers but the brokers who will be the customers to the company. The company's current product lines will need revision before they will find acceptance in the brokerage market. They cannot expect to compete with the larger companies which provide a full line of products and services to this market. Upon entry into the brokerage market the company would find itself competing on a bid price basis. The ABC Life may create a strain on its profit margins due to this influence. Its desired rate of growth must be balanced against the desired level of long range profits. The entry would represent a change to the company, but not an insurmountable change. The available in-house expertise would have to adapt to dealing with a new client base, whose needs are different from those of their career agents. They should consider bringing in additional marketing expertise.

This expansion route has the appeal of a low initial investment and lower marketing expenses than those of a career agency operation. There would be a moderate risk associated with entry into the brokerage market which would be twofold: first, it would be difficult for ABC Life to be competitive in that market; and second, the company would lose some control over the quality of business which it assumed. The company should expect moderate short term losses but substantial long term profits even though these would be expected to be less than the profits derived from the business placed through their career agency organization. In the long run, the company would have less control over the amount and quality of the business acquired, and, therefore, would have less ability to predict the level and incidence of profits.

For expansion of the current operation into a program of mass marketing, there would be a new set of target markets and marketing practices. This would be a major problem since it is assumed that they have no current relationships with third party sponsors, or access to any significant affinity groups. The company should consider an initial entry into the association or franchise business. Any products which are offered would be new to the company. The product development projects would represent a significant undertaking since the company has no knowledge of the market place requirements, or of the experience expected from the mass marketing business. The most reasonable growth strategy for the company would be an entry into some relatively familiar specialty markets. The company would probably want initially to enter the group trust market with the offering of association or franchise group products. Any business produced should be considered supplementary to their basic growth patterns. Their lack of expertise would represent a significant problem. Before initiating any development, they should acquire assistance or additional in-house expertise.

A development of a capable mass marketing operation would involve a significant initial expense since the company has no experience in this area. After entry, the ongoing marketing expenses would be quite low and this would be the appealing feature of mass marketing to the company. However, this distribution option offers the highest risk to the company. They will have trouble in developing successful marketing practices, and in pricing and controlling the quality of the business. The first factor involves a significant short term expense risk, and the second involves a long term profitability risk. Mass marketing profit levels are much less predictable and are expected to be lower than those of their direct business. Under this system long range expected profits are normally compared with marketing expenses, and the profit patterns are viewed in a different light.

MR. SANFORD W. SCOTT: I would rather focus on retaining as much of the $20 million in capital and surplus as possible and turn my attention to the market through the multiple line insurance agent. I will make one assumption on ABC Life, that they are a life affiliate of a property and casualty company. This does not automatically mean that they have been doing business with the multiple line agents of that property and casualty company, so I will assume that they have not.

I would like ABC Life to ask itself four very simple questions. First, what market might ABC penetrate successfully? The primary market for the usual life company is the agent, not the consumer, when dealing with a multiple line operation. The secondary market is products and programs for which there is a consumer need.

The second question concerns what features ABC has or is willing to develop on which it might capitalize in attracting agents. Some items to be considered are commission structure, premium rate levels, agent fringe benefits, geographic location, underwriting standards, and administrative services.

Third, how much capital and personnel resources does the company want to dedicate to the new marketing venture? We must consider the deterioration of capital and surplus in the property/casualty business over the last few years. The property and casualty parent will be very wary of allowing the life affiliate to reduce the $20 million capital and surplus to $10 million.

Finally, can the business be acquired within the acquisition expense limits included in the premium rates? That is, will business acquired through the particular distribution system meet the profit standards of ABC Life?

I suggest that ABC Life examine the multiple line agent relative to each of these questions. The multiple line agent potentially is an excellent source of business. He varies from a novice producing extremely little life insurance in his agency to a very large property/casualty agency with one or more professional life men on its staff. His primary income is from property/casualty business and that also draws most of his attention due to the service work involved.

This agent possesses a very unique relationship with its clientele, a much closer relationship than the typical life insurance agent. People deal constantly with this multiple line agent: they have a claim, they have a question, they bought another car, they are thinking of buying a home, they are wondering if they are fully covered with property and casualty needs. Therefore, when he calls them to review their life insurance program, he has a much greater possibility of getting in to do just that than does the pure life man who calls to do the same thing.

Typically, if he is producing any life business at all, he is producing for one or more life affiliates of property/casualty insurance companies, and some with pure life companies. At Commercial Union, we want to be either the first, second or third company in an agency which gives us a very strong position to attract life insurance.

Additionally, I believe that the agent is sitting on a gold mine. His large file is a pure lead list. It alludes back to the close relationship he has with his clientele which, for the most part, he has not developed.

The secondary market is determined by the company's products and marketing programs. Typically, the multiple line agent wants a well-rounded portfolio that is reasonably competitive. He prefers a company that is in all life lines so that he might be the sole agent servicing all of his customer's needs, including property/casualty, life, health and retirement needs.

Next, examine those features which might attract an agent to ABC Life:

1. Commission structure. Generally, commissions from his life business are not of great importance to this particular agent since his primary income and attention is taken up in the property/casualty business. He is satisfied as long as the commission rates from ABC are in line with those of other companies. However, the one great exception to this is the agency with its own life department. There, one must go in with a top commission scale, along the personal producing general agent line.

2. Premium rates. The closer to novice the agent is, the lower he wants the premium rates to be. He does not want his client to find lower rates available elsewhere because he fears this may lead to the client reassigning his property and casualty business.

3. Agent fringe benefits. In this area the agent will be interested in whatever is available.

4. Geographic location. This has been exploited very successfully by some regional life companies that operate in a very defined geographic area.

5. Underwriting standards and services. The agents want quick, efficient processing and the company is constantly in competition with the processing he obtains from his other life companies

How much capital and personnel resources are required? The initial development of multiple line agents by a life affiliate of a property and casualty company now requires relatively small amounts of capital. Typically, development begins from a local branch office already in existence which can be staffed either with or without a full-time life employee. If a full-time life employee is to be used, the capital outlay is limited to his expenses. He is compensated either on a straight salary or a combination of salary plus override commission. So, there is a very limited capital requirement in the life development if the life development can be piggybacked onto an existing field complex.

Can the business be profitable? Whether or not the business can be acquired with an acceptable expense depends on several factors. First, there is the question of production. Assuming that ABC is a life affiliate of a property/casualty company, the dedication of the parent to life production from its property and casualty agent is absolutely essential. Due to the very tight market in the property and casualty world, the property and casualty company that is really interested in producing life business will be in a very unique position to put pressure on agents to get life business. The influence upon this agent by all of the employees of the branch is very important - not only the life agent, but the branch manager, the underwriters, the claims men, with everybody stressing the fact that the company is serious about producing life business.

It is also important to develop programs to attain consistent life activity from the agent giving ABC Life its business. Another very important factor is the penetration of this agency force, meaning the percent of the parent's agents producing life business. Certainly, with more agents producing, you would increase your sales very substantially. The compensation level of the life employee has a significant effect on the acquisition expense levels. It is basic to marketing success that the employee be compensated on a minimal salary plus incentive basis, which will enable the company to control its expenses and encourage production from that particular individual. Another important item in total expenses is the role the life employee plays in the sales process. If he is actually making the sales with the agent, the expenses will rise per unit sold. Depending upon the particular approach that ABC Life would take, they will have to build into their acquisition costs the role of this life employee.

In summary, ABC should consider marketing through property/casualty agents. The initial investment is minimal, the profit potential, if compensation and method of marketing are structured properly, can be very significant.

MR. JAY M. JAFFE: Mass marketing is a very broad topic and one that requires a definition. I shall define mass marketing to be any form of marketing that circumvents the traditional "one-on-one" sales process between the agent and the prospect.

There can be several motives for a company to employ mass marketing techniques. Such reasons include: (1) development of an alternative distribution system, (2) taking advantage of markets that cannot be reached economically through independent agents, (3) creation of leads for agents, and (4) sales of other or "load" products to present customers.

The key to most mass marketing ventures is the link between the company and the prospect. This is usually accomplished by the endorsement of a sponsoring organization. For example, a letter from an association to its members describing a program is an excellent endorsement.

In the eyes of the prospect, the endorsement establishes the credibility of the carrier and its products. This will increase participation, lower acquisition costs, provide better mortality, etc. In addition, it is helpful but not mandatory that there be an automatic billing mechanism to facilitate premium payments and to remove them from the decision category. Examples of such systems are payroll deductions or credit cards.

These are four major centers of influence around which mass marketing can be developed: (1) employment centers, (2) financial centers, (3) shopping centers, and (4) associations or affinity groups. These groups possess the endorsement potential and often have a convenient system for billing and collecting premiums.

In order to enter mass marketing a company must be willing to revise or change its operations. Mass marketing requires different policy forms, point-of-sale materials, special reinsurance, systems geared to non-personal communication, altered claim practices, etc. Once a company recognizes the mechanical hurdles, it must also be guided by the following: (1) Don't dabble, (2) Be prepared to invest large sums of money up front before receiving any premiums, and (3) Be willing to accept that mass marketed products are often less prestigious than agency type policies. A venture in mass marketing can be expensive. A company should commit itself slowly to any new area and mass marketing is no different.

An important element in any mass marketing program is talent. The cheapest way for a company to enter mass marketing is often to buy experienced personnel rather than using the trial and error method.

Compensation in mass marketing situations is geared to the particular circumstances. In the employer market, the agent is normally paid a commission, the level of the commission being dependent on how the leads are obtained. If the company obtains the leads for the agent, his commission will be lower since he is not paid for prospecting. The attempt here is to make the agent more productive so that he can make more sales in a given amount of time.

Under the financial center concept, the commission scale can be varied to reflect the particular circumstances of the specific market. For example, in the stock brokerage market, a more level commission contract can be used. Since it is a supplementary line of business, large front-end loaded contracts are not necessary.

Under the shopping center concept, commissions again are generally lower since the customers are going to the agent rather than the agent going to the customer.

The association market involves three forms of compensation. There is a commission paid to the agent. There is an administrative allowance generally paid to the administrator, most often expressed as a percentage. And there may be some form of compensation paid to the association for the use of its name.

Finally, profit exists in mass marketing for those companies with perseverance but each opportunity must be evaluated individually. The Equitable (New York) says it best: "No two people are exactly like you". This is probably the most important realization for any company getting into mass marketing. It is a difficult concept to grasp, but subtle changes between markets make a world of difference. Recognition of such characteristics mean the difference between a successful mass marketing operation and a distasteful mass marketing experience.

MR. WOJCIK: One point of reference no one discussed this morning is the concept of the over-the-counter purchase. We have been selling our casualty products over-the-counter through booth operations in California and Illinois. Since we provide the salesperson with a place to work, since he will be dealing with walk-in business, and since products sold through this market must be highly competitive, we do not use a commissioned salesperson, but rather a salaried one.

MR. JAFFE: I want to make one further point. As actuaries, we sometimes get stalled by what the mortality or persistency of a product will be and we forget that the major risk that is involved in selling insurance, is the marketing cost risk. It's not the mortality, it's not the expense, it's not the persistency, it's the marketing cost risk because that represents dollars invested that cannot be recovered if they are too high.

MR. ROBERT L. RUDERMAN: We are very involved in direct marketing business at Beneficial Standard and the question I want to ask concerns the legal environment. We are finding that both advertising and policy language are being very toughly hit by the states and in different ways so that we have to develop different advertising copy and policy forms for individual states. I would like to know if any companies are dealing with the states in any way that might help to ease this problem.

MR. JAFFE: I think you have posed the problem very well, and I agree with you. I think it's just one of the prices of doing business. Until the last ten years, the rule was let the buyer beware. In the last ten years, there has been a different situation, let the seller beware. True, we cannot deceive the public and I grant you there have been abuses, but the expense that is involved for adherence to the various regulations is fantastic. However, everybody is facing the same situation, no matter what the distribution system is.

MR. WOJCIK: A company will not survive in the mass marketing environment with an actuary and/or attorney who remains in the office. You must have a person who will resolve questions regarding the drafting of advertising material and policy forms by discussion with the state department in order to eliminate much of the expense and delay of written communication back and forth. You need people to react and communicate well with the department on an immediate basis.

MR. RICHARD W. ZIOCK: I would like to bring to your attention a new application of statistics to marketing. The statistical technique used is discriminant analysis, and the application is to sales prospect screening.

Discriminant analysis develops a scoring formula involving predictor variables. In applications, the formula's score for a particular case is used to decide whether or not the case falls in one group or another. For example, banks are using such formulas to evaluate credit applicants. The predictor variables, from the credit application, include length of time at current residence, number of years in present job, number of children, etc. The predictor variables are weighted and added up as called for by a linear formula. The resulting score is then used to decide whether or not to grant credit. Usually a high score means acceptance and a low one means rejection of application. The predictor variables are perhaps not the ideal ones, but they are ones which seem to surrogate for the real influences. Also, the predictor variables must be available without extra expense. The scoring formula is constructed using past credit applications and the past credit histories. Usually equal numbers of good and bad credit risks are used.

Discriminant analysis is being used in many business applications. I have been fortunate to have had the opportunity to develop two applications of discriminant analysis to insurance marketing. They are the selection of term conversion and repeat buyer candidates. Both of these applications seem profitable since the data base is huge and the cost of canvassing high. Both applications were successful in that significant improvements in predicting sales were achieved. In the term converter study a term policy was scored for its likelihood of converting to permanent insurance in the following year. In the repeat buyer study, the score was used to judge the likelihood a given policyholder would purchase another policy in the coming year. Both can be used to develop lead lists for agents. I will not go into the technical details of these studies such as the predictor variables at this time; they were discussed intensively in a paper titled "Predicting Policyholder Behavior" by myself presented at the Ann Arbor Research Conference, which was subsequently published as part of the proceedings of that conference in ARCH. Finally, I would like to point out that usually statisticians are the executors of such studies but actuaries can be involved profitably in applications such as those described above because of their better understanding of the factors involved in the insurance situation.

MR. WOJCIK: Dick made an interesting point. When we decided to close out our agency operation, we went back and recaptured all the data on every policy that was issued and had lapsed over the last three years. We are now running an analysis on the agency-sold policies to determine the characteristics of those persons who lapsed and of those persons who survived. We are matching that information against our general profile of the buyer at Wards to determine whether or not there is a segment of the Ward market that will buy from an agent. In fact, we are testing a different marketing approach now, using the scoring techniques. After we have been able to get some results, we will be glad to tell you about them in future meetings.

CANADA LIFE: We have had an interesting debate as the Moderator suggested we would at the beginning, with Mr. Hogue in favor of extending career agency marketing, Mr. Scott emphasizing what one can do if he appeals to the multiple line agent and Mr. Jaffe concentrating on mass marketing.

I would like to extend the debate somewhat by asking if we know of examples of a company that starts out with a career agent operation being able to move over to one of the other marketing operations totally and completely without loss of its identity and investment. Mr. Jaffe, were you intending for ABC Life, which started with career agent development, to have mass marketing take over as its primary method of marketing or would it be a sideline, an experiment, that it would deal with in a partial way?

MR. JAFFE: A complete and total switch will not work. The company must build it in slowly to avoid a disaster - it must not commit too much money initially. There are companies using both methods currently that did not begin by using both methods. The roles can be complimentary, they are not mutually exclusive.

CANADA LIFE: I would like to ask the same question of Mr. Scott. I wonder if there isn't some danger that a company will lose its identity in dealing with multiple lines after it started as a permanent company.

MR. SCOTT: That is a similar question to whether a career agent company should operate in the brokerage market. There are many companies that operate successfully in both of those markets, so ABC Life might well be able to move into the multiple line agent market without greatly disturbing any other type of agency operations they have going.

The question concerning mass marketing is interesting. There is a great fear that the agents of an agency oriented company will become greatly disturbed if the company moves into mass marketing. But actually, there is a considerable difference in the products. Mass marketing deals with a very unsophisticated sale, usually taking place through the newspaper or the mail. The product must be extremely simple or the public will not respond. If the public relations work has been done properly, a company can run both an agency system and a mass marketing system together.

MR. HOGUE: ABC Life would have the option to do some mass marketing. However, I would put three requirements on what they do and I would make it a supplementary type of approach.

The first requirement is that the groups would be their current policyholder groups. The second requirement is that the product they offer should be something that is a specialty product and is not in their current portfolio so they do not compete with their agents. And third, they should use and compensate their agents - the agents should not be excluded from any marketing effort they have.