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Penetrating the Elusive Middle Market for **Life Insurance**

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THE HUGE OPPORTUNITY

As our industry continues to struggle to find new markets for growth, one of the obvious opportunities is the fact that a large percentage of the middle market either has no or too little life insurance. Let's define this market as heads of households and their spouses aged 20 to 65 with annual incomes between $25,000 and $75,000. Conservatively assuming there are only 50 million people in the United States today in these age/income ranges, and on average their life insurance protection shortfall is $100,000 (within a range of $50,000 to perhaps $500,000) that would cost them $250 per year, this represents a market size of $5 trillion face amount and $15 billion in recurring annualized premium. If a life insurer were able to achieve a 1 percent penetration, that would add $5 billion of face amount and $150 million of annualized premium to its life insurance portfolio. Since this opportunity and its potential size are no secret, why have we not seen any significant success?

THE DAUNTING CHALLENGES

Three key factors come to mind that explain the "why not":

1. *"Everyone" focusing on the big sales.* Most of our industry's life insurance sales focus is driven by traditional life insurance agents who, naturally, have increasingly focused on maximizing their income by focusing on selling larger policies to the healthiest people—a saturated, low-margin market for insurers.

2. *High distribution costs.* For those agents just starting out and/or focusing on this market, the distribution costs for life insurers must be set at the highest first-year commission levels such as 100 percent or more in order for the agents to attempt to make a living by selling greater volumes of these smaller policies.

3. *Higher underwriting and mortality costs.* If one were to spend $500 for a medical underwriting process, this represents only 5 percent of first-year premium for a "larger" policy whose annual premium is $1,000. However, it represents 200 percent if the annual premium is only $250, which renders this approach unfeasible since total first-year acquisition costs would be 300 percent of first-year premiums. If a typical simplified underwriting process is applied, the underwriting cost might be reduced to $125, but that is still 50 percent of premium resulting in 150 percent of first-year premium total acquisition costs. In addition to these high relative-to-premium cost levels, the expected mortality would be materially higher due to the simplified underwriting.

Even though price per unit is less of an issue compared to the high policy size markets, this combination of high total acquisition costs and higher mortality would add pressure in the effort to balance "affordable" premium levels versus reasonable profits.

ONCE UPON A TIME THE INDUSTRY MADE IT WORK

Ironically, those of us who have been around many years—or have had the occasion to review the industry's history, or work on evaluating the profitability of closed blocks in demutualizations—realize that many of the largest, long-standing life insurance companies built their businesses through successful focus on the middle market through their debit distribution channels. Debit agents walked their neighborhoods and sat at the kitchen tables of their prospects selling them small amounts of life insurance and then returning each week to collect the premium and upgrade their clients' life insurance coverage. Since they generally "walked" their debit territory, the time and cost to cover their territory were minimal. Both the sales volumes and the profit margins were high, but over time the economics for the sales agents eroded so this approach went the way of the buggy whip.

As these debit operations closed down, the industry's focus on the associated market segment waned. Over recent decades, the industry has attempted to refocus on this segment, with mixed success, through more efficient distribution methods. Four of these are controlled distribution via lead generation, worksite marketing, direct response and more recently the Internet.

For a new approach to the middle market to generate high volumes and strong profit margins, it must have the following three attributes:

1. *Scalability.* Provide the insurer with sufficient control over the sales process so as to generate large volumes of sales per period of time.

2. *Reasonable distribution costs.* Contain total policy acquisition costs expressed in terms of percentage of first-year premium at a level no greater than that for traditional distribution of larger policies.

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3. *Underwriting process with reasonable mortality costs.* The expected underwriting process applied must balance acceptance rates with a reasonable level of expected mortality. If overly loose, sales volumes and distribution costs may improve but expected mortality will be extremely high. If overly restrictive and long-winded underwriting processes are used, while expected mortality costs will be low, the number of sales and the cost of sales will be too high. In either case, the resultant product pricing precludes the ability to offer this market a reasonably priced product they can afford with meaningful benefits

Lead-generator independent marketing organizations (IMOs) aim to develop controlled distribution in terms of productivity and lower agent commission costs by taking on the job of acquiring and/or developing qualified leads for their agents and then carefully monitoring how the agents follow through on these leads. Since the IMO's agents are freed from prospecting, they can focus their efforts and their financial resources on closing. Since this positions these agents to materially increase the number of sales calls and sales closed, they are willing to accept lower commission rates from their IMO lead providers than agents who must prospect, sell and close all on their own. One might think this means these agents are spending 100 percent of their time closing sales. However, since the agents must travel to each prospect to meet with them in person, their effective time in front of prospects working on closing might be 80 percent or less.

The travel time and cost is much more significant in this middle market for life insurance than other markets because the agent can only visit so many prospects in a day, and even if his/her close rate is high, the sales commission on small face amounts of life insurance severely limits their income potential. For example, if they are able to visit four prospects per day closing 15 percent of them where the commission rate is 100 percent of first-year premium and the average premium is $250 per policy, their expected weekly income is only $750 or $37,500 per year less the cost of transportation to make these 20 sales calls per week.

Worksite marketing effectively executed has demonstrated meaningful success. Through its "enroll many people in short period of time at one location," it offers sales productivity for the sales force but does not particularly lower the insurer's distribution costs if the same retail commission structure is paid as for other business. In the absence of a straight-through/instant-issue underwriting process, getting back to the applicant is more streamlined than one-off sales at people's homes.

Direct response has produced less than stellar results overall in penetrating the middle market for life insurance. The exceptions would be very specialized programs such as guaranteed issue life sold to seniors to provide burial insurance and coverage endorsed by life insurer company marketing partners where customer affinity (i.e., response and conversion to paid policies) is very strong. Product offers focused on younger age groups offering higher amounts have encountered (a) high anti-selection due to low response; (b) low sales volumes; and/or (c) high sales costs when insurers rent access to higher responding prospects from entities such as banks and other groups where there is strong affinity with the group.

Internet-driven sales had been assumed to be the solution to reducing the cost of getting in front of many prospects quickly inherent in the above methods. However, to date, these favorable distribution economics have failed to materialize. The first problem is that life insurers have found they must spend considerable marketing dollars driving traffic to their sites. The second problem is getting those who do visit to follow through and apply for the insurance. The result has been too few sales whose cost per sale is as high as or higher than the equivalent traditional agent commissions. The experience to date tells us Internet sales to the middle market fail to provide either of the two required attributes named above.

The overall results from these approaches to the middle market for life insurance have been less than encouraging, resulting in a market that looks very attractive but seems unobtainable on an economic basis.

NEW HELP ON THE UNDERWRITING SIDE

Common to all of these approaches (and the market for larger policies) is the negative impact of not being able to instantly issue the policy. At a minimum it loses sales opportunities at the front end of the sales process. At a maximum, it raises the paid business acquisition

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costs through lower paid rates as applicants decide to not complete the underwriting process and/or get tired waiting for it. The recent and evolving developments in the field of automated underwriting seem to provide a remedy for this.

The technology now exists to support a process where, either in person or on the Internet, interested applicants can apply for life insurance by answering a reasonably short list of questions and know within a short period of time (as quick as within 15 minutes or so) if they will be able to complete their purchase. Of course, the old simplified issue process did this, but based upon total reliance on the applicants' responses to a small number of questions, exposing life insurers to higher-than-expected mortality and/or higher-than-expected legal disputes as to applicant misrepresentation or both. The new technology replaces the old written application with e-application and then dramatically reduces this problem by instantly linking to external databases such as the Medical Information Bureau (MIB), the state motor vehicle department, prescription medication databases and others in order to validate the applicant's responses to the point-of-sale questions.

The challenges are (1) the time and cost to develop these capabilities and (2) the lack of credible industry mortality data upon which to base product pricing mortality expectations. To date, while a few life insurers have developed their own systems, most of the progress in developing these capabilities has been achieved by the reinsurers. The reinsurers, like their direct writer customers, have also had their eye on this middle-market segment. Rather than continue to wait for the direct writers to develop the necessary breakthroughs in reducing the poor economics of traditional simplified underwriting processes, they have decided to lead the process. Their reasoning is that if they could offer these automated underwriting capabilities to their clients interested in penetrating this market and overcome their clients' fears about the uncertainty of the mortality inherent in this new approach through reinsurance, perhaps more of their clients might focus their efforts to find productive ways to sell in this market.

These automated application and underwriting capabilities, often referred to as straight-through processing (STP), offer a solution of the "relatively high issue costs" and higher mortality costs barrier to success in the middle market for life insurance.

STP is the solution to the reasonable balance between underwriting process and resultant mortality expectations but leaves us with the other two challenges and a new one: (1) scalable sales volumes; (2) reasonable distribution costs; and (3) uncertainty as to the mortality levels resulting from STP.

CAN/WILL THE REINSURERS STEP IN?

Recently the CEO of one of the large, global life reinsurers speculated in his investor day presentation that rather than continue to wait for the direct writers to develop this market, perhaps the reinsurers should do it. This reinsurer (and others) already has the STP capabilities and a conviction as to the mortality levels associated with STP. They could establish direct writers and go after the market. This executive reasoned his direct writing customers would not be taken aback if the reinsurers were penetrating a market they had largely given up on.

The challenge for the reinsurers is that they have no distribution so they would have to develop it. This either leads them back to their life insurance clients or other sources of customers such as banks and other entities controlling customers. While bancassurance in Europe might have demonstrated one way this may work, the success of this approach and/or others discussed above has not fared well in the U.S. market. The distribution challenges remain. ■