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THE FUTURE OF DISTRIBUTION SYSTEMS

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- o Sources of traditional agent issues
- o Trends in employer-sponsored sales
- o Successes with financial institutions
- o Developments in direct-response marketing

MR. ROBERT P. HILL: The career agency system is alive and doing well at The Prudential. The early 1980s was certainly a challenging period for us as well as for other career agency systems, but we have fought our way through the period and have come out in fine shape. While our field force size has slipped slightly, first-year commissions per agent have increased at a compounded annual rate of 10% over the last five years.

What's happening with the career system in the rest of the industry? According to the Life Insurance Marketing and Research Association (LIMRA), there have recently been signs of a recommitment by other insurance companies to the agency distribution system. In 1986 the number of full-time agents hired by ordinary companies was up 6% compared to 1985. Hiring of inexperienced recruits was up 7%, and about 70% of all agents hired during the year were inexperienced. Furthermore, the 4-year survival rate for agents jumped to 20%, a significant improvement over historic levels.

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What has caused this improvement? LIMRA credits companies being more selective in the people being hired. But to be more selective as a recruiter, you've got to see more and/or better qualified prospects. I think we are attracting more and better people because of our new, exciting products combined with greater confidence in the future by field representatives. The best sources of new recruits has always been personal referrals and perhaps the most commonly used source, advertising. In either case the greater interest in life insurance in recent years, and the generally more successful atmosphere, have encouraged people to become agents.

The Prudential has done some experimenting with additional channels of distribution. We've expanded our life insurance brokerage operations and added Prudential-Bachc as a major distribution arm. But it's still the two career agent organizations that do the great bulk of the business. My talk will focus on these organizations.

The district agencies organization is composed of almost 20,000 agents and members of sales management. Their mission is to serve the insurance and other financial security needs of individuals, families, and small businesses in the broad middle-income market. They employ what we call a multiline strategy, under which an agent sells a broad variety of products and is responsible for servicing a specific area. A new agent is given a large client base of customers which provides an excellent prospecting source. This organization is a highly structured and broadly deployed, exclusive agent distribution system.

In terms of number of sales, 45% come from life insurance, 20% from property and casualty, and almost 30% from mutual funds and annuities. Health insurance has become a relatively minor part of our operations.

The ordinary agencies organization has over 4,700 agents and members of sales management. While product availability is the same as for district agencies, this organization is aimed at moving agents into the upper and upper-middle income markets. The emphasis is on life insurance as the client control sale. Nonlife products are used for prospecting and are generally provided through a functional specialist rather than through the agent himself. Nearly 80% of the commissions are generated through life insurance sales.

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With this general background regarding the career agency distribution channels, I would like to turn to the key challenges we face. The biggest challenge is maintaining our growth and market share over the last decade. In the middle-income market, the life insurance oriented sales forces in general have not enjoyed the same kind of success as the property and casualty (P&C) oriented distribution systems. State Farm, Allstate, and the Farm Bureau companies, to name a few, have done very well over the last few years operating from a compensation base of ever-inflating automobile and homeowners premiums. They have taken a good deal of the P&C market share away from the independent agency companies.

In addition, these companies are all putting heavy emphasis on life insurance sales and doing increasingly well. Agents in these systems are accustomed to covering their own expenses of their operation and achieving high levels of productivity. Life insurance companies look at the levels of P&C productivity with envy. Gradually the P&C oriented agents are increasing their life sales to the point where the average agent, as a side line, is selling 50% to 75% as many life policies as the average full-time life insurance salesman.

Particularly in the district agencies organization, we have also been trying to utilize the advantages of P&C marketing. It's certainly easier to approach a prospect regarding homeowners or automobile insurance than life insurance. But once the door is open, we have found that the assumption of cross selling of additional product lines has not been achieved as often as we would have liked. The economics of the P&C business are established by the professionals. It's extremely difficult to balance the need for competitive rates and the need to make a profit. We have done relatively well, but after 15 years we are still learning.

Another challenge from an environment focused more and more on brokerage is: How do you keep your agents selling your own products? We work very hard at justifying the loyalty of our career agents, and we expect to get such loyalty. The district agents and inexperienced ordinary agents have a contractual obligation to give all their business to The Prudential. Some may consider this to be unrealistic, but I can't claim we have any violations of our contracts. Surely you will not get loyalty if you don't expect it.

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We provide our agents with a very broad product line so that they really do not have a good reason to go to other companies. We may not be the most competitive everywhere for every line of business, but there is the convenience to both the agent and the customer in dealing with just one company.

We recognize that we have to work hard to promote The Prudential as a company apart from the current prices or illustrated cost of our products. If you let the sales situation revolve strictly around price, you can't consistently win. Therefore, we stress the advantages of dealing with The Prudential; you can't price service, size and strength, integrity and security.

Loyalty also comes from the belief in the organization and its future. To instill this belief you need strong leadership with a strategy and vision of the future that is understood and accepted. We also do our best to instill personal loyalty between agents and managers. This is done through extensive on-the-job training, very close management attention and supervision. Agents are certainly people-oriented, and they respond to good people management practices.

We also work very hard on the education of our agents. One aspect that has been particularly helpful is building the understanding that the sales illustration is only an illustration. The actual results will depend on actual performance; particularly with regard to investment earnings. We are doing our best to explain the importance of the asset mix and investment selection on product performance, and we naturally promote the abilities of our professional investment staff.

Our strategy to emphasize registered products, such as variable universal life, fits very well with the stress on our investment abilities. Our representatives are registered only with our broker dealer, Prudential Securities, and they are very bullish on our ability to produce excellent results. So, in summary, over the years we've supplemented our product line with auto and home owners' coverages as well as offered mutual funds and other financial services. We've also broadened our distribution channels somewhat, but we have not strayed far from the admonition to "stick to your knitting," which in our case consists of marketing the long-term value of permanent life insurance through the career agency system.

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MR. STEVEN J. ABRAMSON: The most successful life insurance product in recent years has been universal life (UL). This product has now been sold to employees using several different distribution systems. It is, therefore, useful in illustrating the trends in employer sponsored sales.

My remarks will cover the UL product with an emphasis on the group distribution system. When talking about group UL trends, we must realize that a trend in the group UL marketplace is something that stays consistent for more than two days in a row. If it lasts for a week, we call it a miracle. I will also try to provide you with some of the concerns actuaries must deal with in shaping these products to meet the needs of the market.

First, let me set the stage by providing you with a short history of the product; and for those of you who are not familiar with group UL, I will briefly describe the major features.

The UL concept has been around since 1979 when E. F. Hutton was generally credited with coming up with the idea. Universal life was first widely sold as an individual product in 1981. By 1985, over 40% of all new industry ordinary premium was attributable to UL sales. To add a Metropolitan perspective, in 1985 over 75% of our ordinary life premium was attributable to UL sales. As a result of its success, companies began to look for additional means of distributing this product. What better way to go to the masses, than through the employer. Several companies, including Metropolitan, decided to sell the personal form of the UL product on a wholesale basis at the workplace. I have not seen any industry results for this method of distribution, but I know that Metropolitan is selling aggressively.

Another distribution method for this product involves direct mail marketing. Associations of many types are interested in providing UL coverage to their memberships. These products are underwritten similarly to personal insurance. Group products are being developed to address this market. I am aware of a few cases sold to date.

While the mass marketing method on a personal form was emerging, several concerns were heard from the employer community which caused companies to develop a true group form of UL. When employers became more concerned about

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rising employee benefit costs, they began looking for ways to reduce or at least stabilize these costs. These same employers were waking up to the tremendous post-retirement life insurance liabilities they were facing. The courts were making it clear that deliberalizing retiree benefits would not be easy. FASB decreed that the employer financial statements would have to state this liability. DEFRA then placed limitations on tax preferred post-retirement reserve accounts.

In addition, employees were complaining about the rising imputed income tax consequences of group life insurance over \$50,000. The IRS was changing the rules governing taxation of these benefits. Employees were asking why they had nothing to show after years of payroll deduction for term life. Employees also wanted more of a voice in deciding their benefits package.

More employer concerns were heard. The charges to a group contract when a terminated employee converted to an individual life policy were becoming a bigger concern to employers. The average charge was \$60-\$75 per \$1,000 of converted policy. Then, of course, discriminatory plans came under intense fire. Each succeeding tax law exacerbated this concern.

Finally, not all employers were willing to accept individual policies and underwriting. Many employers wanted the mortality portion of their payroll deduction UL plan to be experience rated in a traditional group fashion. Some employers believed that group policies were more cost efficient.

As a result, group UL was created. The first product reached the market about two years ago. The Tax Reform Act of 1986 has had a dramatic impact on this product, not from the changes to the product, but rather the changes to other products which are natural competition to it. I won't discuss this law because it's beyond the scope of the agenda, but suffice it to say that sales are increasing rapidly.

The marketing of group UL usually begins with a presentation to a broker or an employer. The first thing to explain is that any UL product is a combination of term insurance and an accumulation fund. The accumulation fund provides the product's cash value. From a functional standpoint what happens is this: the employees contribute to the plan through payroll deduction. All employee contributions flow to the employees' accumulation fund. Even though we are talking

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about a group product, it is important to know that each employees' accumulation fund and plan transaction records are kept individually. Once each month our system, which maintains these records, deducts from each employee's accumulation fund the pure cost of term protection and monthly administrative expenses.

Because of the expense structure associated with group UL, employee funds build rapidly. Once they have done so, employees are free to borrow or withdraw their money. At retirement, employees have several choices including continuation of group UL coverage, paid-up life insurance, or cash withdrawal.

There are two popular death benefit options associated with UL products: Options A and B. Option A works very much like traditional whole life insurance where the death benefit is equal to the specified amount. Fundamental to option A is the concept of level premiums. Level premiums make it possible for the term portion of the contract to decrease over time as the cash value portion increases proportionately. The important thing to remember with an option A contract is that the death benefit remains level.

Death benefit option B provides a flexible death benefit. With this option, the net amount at risk is fixed. The death benefit is comprised of this level amount of term insurance plus the balance in the accumulation fund.

It has been our experience, almost without exception, that option B enjoys the greatest success in the group marketplace. There are several reasons for this; but probably the foremost reason is that, within the employee benefits environment, both employee benefit managers and employees are generally familiar with the concept of a level amount of term insurance.

The nature of the option B death benefit and its easily identifiable fixed term element and separate savings element, makes employee communications much more straightforward. Option B also permits greater contributions under the federal maximum guidelines than option A coverage for the same face amount; a concept which is not lost on the highly paid decision makers.

One of the differences between group and personal products is the ability to relate the coverage to salary. Target premiums also can be customized to meet the group's needs as well as those of the individual. In contrast with traditional

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group term insurance, you can keep the coverage if you leave the employer. We call this portability. The rates may or may not change when the employee becomes portable, depending upon the plan's structure. You may borrow against the cash value. This feature will probably receive much less activity in light of the new tax law. You may withdraw money from the cash value. In contrast with withdrawals from pension plans, there are no tax penalties. This product is currently subject to typical life insurance taxation. Higher paid employees are most influenced by this, but everyone benefits from this feature.

There is intense competition here as companies are vying for market share. The interest battles in the group environment have not yet been quite as ferocious as in personal insurance.

Surrender options include paid-up life insurance, cash surrender, continuance of the UL coverage or purchase of an annuity. For group plans, there will typically be a termination of plan provision. These provisions tend to vary quite a bit, but the provisions are usually divided into two circumstances; termination with a successor plan and termination without a successor plan. Some of these provisions allow the individuals to remain covered even though their payroll deductions have ended. Other provisions involve extended payouts of cash values, surrender charges, or market value adjusted payments.

Now let's look at the group distribution system. First, there is the sale to the employer. Group UL is a rather complex product. A company with commitment to the marketplace will need to develop a staff, expert in the plans available. This staff will train the group sales force and is available for consultation with employers and/or brokers.

For large plans, the terms and conditions of the contract are tailor-made to meet the needs of the client. The tailoring of group UL takes place as a negotiation process. A broker or consultant is usually involved. It is important that the actuary be directly involved because seemingly minor changes in the plan features can have major cost impacts in the future. Smaller size groups tend to have more standardized plan provisions.

An added complexity in the group environment is the positioning of the product versus optional term insurance. There are the two forms in use today. The

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first form is a combination plan in which every certificate is a UL certificate. In this plan, the employee may choose to contribute only the term premium and expense charges or contribute additional amounts to build a fund. This form allows the administration costs to be spread over a broader base and provides portable term insurance.

The other form involves two separate plans; one plan is the typical optional term plan, that's without portability, and the other is a UL plan. The employee chooses one of these. This form is less costly to administer because the term plan requires no individual recordkeeping.

In addition to these distinctions, there are a number of complex issues mostly involving tax law, which may cause the employer to favor one form over the other. At least two of the major companies in this market are prepared to sell either form.

UL is different from the typical employer paid group coverage because a sale to the employee is required. To my knowledge, all group UL plans sold to date have been "employee pay all." Unlike employee pay all term insurance, where the product is simple with few employee choices, UL is complex. Let's look at this process. First, I'll give you a very brief sketch of a sample personal insurance mass marketing distribution method.

The personal insurance form of UL sold at the work place usually involves personal insurance sales agents or professional enrollers on a salaried or reduced commission basis. Some introductory sales material is distributed to all eligible employees. The employees then decide if they are interested in learning more about UL. Individual interviews are then scheduled. Enrollment forms are completed at these one-on-one meetings. A typical interview takes about 15 minutes.

The group method starts out the same as the personal approach with introductory sales material. Everything that follows is customized to meet the needs of the employer. A typical enrollment of a geographically concentrated group may be as follows: Group meetings are held in each of the employers' worksites. These meetings may involve between 20 and 50 employees. All eligible employees are encouraged to attend these meetings. Depending upon the employers'

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desires, either an employee of the carrier or a representative of the employer runs the meeting. If the latter is the case, the carrier usually trains the employer representative. The meeting usually consists of an introduction, followed by a video tape or a slide presentation and a question and answer period. Enrollment material is distributed at the meeting.

Supplementing this can be any of the following:

1. Computer terminals or personal computers, at which employees can get answers to "what if" questions about the amount of their coverage or contribution level.
2. Personalized computer printed illustrations for every eligible employee.
3. An 800 number supplied by the carrier for responding to any questions.

Obviously the extent of employer cooperation in allowing the carrier access to his employees affects the method used and the expected results of the enrollment.

Unless the enrollment is well planned, there is little chance for success. Neither the group nor the personal form of enrollment can be rushed. The usual lead time from the date of sale to the employer to the effective date is three months.

I will describe the association business briefly. Enrollments for these plans require special expertise. These plans usually require a mail solicitation. Medical questions are an integral element in this process which automatically adds to the complexity of the product. Design of the literature to accurately describe the product, be understandable, and be attractive enough to elicit a financially viable response is critical to this process. Multiple mailings are usually required to attract an acceptable participation level.

Now let us look at some actuarial concerns for pricing. In competitive bidding situations, each plan feature comes under pressure. Any exclusions or special charges are viewed negatively as the employers seek to get the best features of each bidder in his final contract. Interest rates, mortality costs, and expense charges usually wind up with razor thin margins. As a result, it may take

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several years before a breakeven condition is reached. Persistency becomes the key to profitability.

Actuaries must also be concerned with the enrollment process. There are several measures of enrollment results which illustrate this concern. These are the number of certificates, the amount of coverage, and the amount of fund deposits. From an expense point-of-view, low enrollment creates difficulty in recouping front end and fixed costs. From a mortality point-of-view, a low enrollment will not allow an adequate spread of risks to support the group rates offered. Interest is also impacted by enrollment results. Lower enrollment means less money to invest, and gains from investment results may prove to be the best source of profit in the long run. Therefore, a close communication between the actuary and the marketing staff is essential to assure that coverage is issued on a financially sound basis.

Simplicity in plan design is a key factor in obtaining favorable results. But the most favorable terms and conditions will not sell well unless they're explained properly. For example, offering both option A and option B may be more favorable than only one coverage, but the added complexity may cause lower enrollment results due to confusion. The actuary faces the challenge of balancing the desire for simplicity with exposure to risk. An example of this would be the desire of the employer to have no restrictions or charges connected with surrenders or withdrawals.

In conclusion we can see that the group business is faced with a new type of sale and record keeping when it comes to the employee. The personal business is faced with a new type of sale and recordkeeping when it comes to the employer. The expertise of both lines is needed to efficiently sell group UL. Products such as UL may well serve to blur the lines between personal and group insurance; much the same as is happening in the financial services arena today.

It will be interesting to see how companies react to this. Some may reorganize to bring the distribution of all products at the work place under one organization, while others will allow internal competition between the group and personal lines. There is ample room for creativity here.

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Looking at the environment, we see that employers are concerned with their overall benefit costs and do not want to embark on any new expensive benefit programs. Employees want more say in the benefit choices. The one other dominating environment factor, tax legislation, could move to eliminate the attractiveness of these products. We certainly hope not. Meanwhile, we can look forward to more products being sold on a basis similar to group UL.

MR. WILLIAM M. RING: The direct response distribution system for marketing insurance has been around in varying degrees for a long time. Some of us can remember when you could buy insurance for \$.25 by clipping out a newspaper coupon. Direct response has come a long way since then. It's now big business. It's one of the fastest growing distribution systems in the insurance industry. Let's take a look at why.

First, there's growing confidence and acceptance by the public. Fifteen years ago, surveys indicated that 3% to 6% of the people considering buying insurance would purchase it via the mail. Those percentages have now grown to 25% to 35% and are still growing.

The next reason is third parties, particularly financial institutions who are interested in marketing direct response insurance to their customer base. Our guest speaker, Mr. Schaeffer, will discuss it more.

Another reason is the increasing costs of the agency system, and the realization, pointed out by Mr. Hill, that the agency system just can't cover all segments of the markets. In other words, it's easier to penetrate all the markets by using different and complimentary distribution systems.

Other reasons are the highly manageable, efficient and accurate research, particularly simulated research, now available. The success of other companies has also been a motivator and if done right, there is profitable growth.

The key to success in the future will be to do it right. There was a time when you could mail an existing product from the portfolio to an unclean list and achieve reasonable results, but not any more. The future success of direct response distribution systems will require knowledge of the components of the

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direct response marketing and will also require use of sophisticated direct response market tools.

Success components will guide future developments in the direct response market. The components are the lists that people mailed, the products offered, the pricing of these products, the advertising package, the research and testing techniques, and the legal aspects of the direct response market. Let's briefly discuss each of these.

The key asset in direct response marketing is the lists. In the future, the marketplace will be defined by specific lists and not by broad demographic categories such as the female market, the older age market, the young market. The lists that you control and own will represent the starting point for your direct marketing plans. The product development process will begin with a careful study of this list.

Characteristics of a good list for the future include a strong customer/sponsor relationship. Skepticism is a prevalent deterrent for would-be direct response buyers. It is overcome by trust in the sponsor. The stronger the trust, the higher the response rates, and the higher the profit.

A good list should contain numerous selection parameters, information about the individual other than his name and address. In the future, the list you control will grow in importance. Good lists that you purchase will become costly because of competition. As the costs for those lists increase, the profits will decrease, and the list that you own and control will naturally increase in importance to you.

Look for lists that aren't saturated, that is, they haven't been mailed a lot. The best future lists will also be comprised of people with a strong common interest or affinity, which allows a product to be developed specifically for the list. It's a well-known axiom that people with the highest propensity to buy via direct response are those that have already made a direct response purchase.

For some additional perspective about list selection, which again is the first step in direct response marketing, I will attempt to classify lists for you by

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sources and types. We will rank these from those that have the characteristics of the best, to those that have very few of these characteristics.

The best lists will be your own policyholders. Direct response lists at policyholders are first. That is, a list of policyholders who have bought insurance via direct response, followed by individual policyholders, and then group certificate holders. Next would be third-party association lists: financial institutions, retail stores, oil companies, auto clubs and utilities.

Another source is list brokers. List brokers provide four types of lists. The best list you can buy from them will be lists of direct response purchasers who have done something related to what you're trying to sell them. For example, if you could get a list of direct response policyholders from some other companies, that would be very nice and very related. After direct response purchasers are unrelated purchasers. They have bought something from the direct response mails. Also, there are compiled lists. Compiled lists are those that aren't direct response purchases. Compiled lists come from census information, drivers' licenses lists, telephone books, etc. You may find some demographic characteristics within these compiled lists that you think will be ideal for your market. Of course, be careful of compiled lists that are completely unrelated to what you're trying to do. Last would be direct purchase lists. These are some of the R. H. Donnelly, R. L. Polk lists. There's also a manual out called *The Standard Direct Mail Lists -- Rates and Data*.

When you pick out a list, the work isn't over. It really needs to be cleaned up and segmented. I won't go into all the list segmentation techniques, but I do want to mention some of them. They are list cleaning, live test simulators, data overlays, match keys, and geodemographic cluster analysis. These are all ways to isolate high probability buyers and eliminate low probability buyers. If you're in the direct response distribution system, you will learn a lot more in the future about these devices and other list segmentation devices. You simply cannot afford anymore to take a list and mail it without segmenting it down. It's one of the quickest ways to failure.

Now, a few words about products, another component of direct response marketing. There are three products which currently dominant the marketplace: term

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life insurance, hospital income protection, and accidental death and dismemberment.

A recent development has been to wrap the money-back concept around some of these basic products. It has substantially improved some of the response rates. The money-back concept calls for essentially all or a portion of premium to be returned upon lapse after a certain period of time. A typical period of time is ten or fifteen years.

Lots of products are coming out that are tailored to the characteristics and affinity of the particular lists. Several companies are having success using large lists and creating the products tailor-made to those lists.

You may not want to copy any of these products, but you may want to develop products for old lists that you control or for large lists with which you have long-term contractual relationships.

From now on, add-on products are going to be a must. Add-on products or products sold to existing direct mail purchasers are less expensive to market, have higher response rates and, therefore, have substantially profit potential. Most companies are not going to be able to achieve profitable growth without add-on products.

New companies entering direct response and establishing a direct response distribution system are finding that it is difficult for them to compete and achieve internal rates of returns that are satisfactory, if they establish products identical with products others are marketing well. The reason generally is people do not consider the add-on potential of these products.

There are three types of add-ons. First are integrated add-ons. This type is closely related to a product that the individual just bought. Good examples are the upgrades or fill the gap type offers.

Nonintegrated offers are next. These are somewhat associated with what was originally purchased but not exactly. An option to purchase the coverage for the spouse or an option to purchase accident disability coverage to accidental death buyers are two examples.

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Cross-sells come in third. These are unrelated products mailed to that same list. For example, you might mail an offer for hospitalization insurance to life insurance policyholders. Don't copy and mail, this will probably be a sure road to failure in the future.

Pricing is a little different from individual or group pricing. For example, key assumptions are response rates and solicitation costs. Generally you find that these assumptions will have more impact than even your mortality or morbidity assumptions. Also pay close attention to contractual arrangements. Contracts with third parties are becoming very sophisticated. These provisions can dramatically affect the pricing and thus, of course, the direct response marketing of the product.

Include the impact of add-on marketing in your profitability analyses. Many companies, as I mentioned before, are not doing this and consequently are pricing themselves out of the marketplace.

Pricing is key to proper preparation for research which in turn is key to the direct response market. When pricing for research purposes, isolate costly benefits or procedures for testing. See if they really are generating additional responses. Also, try to price accurately within 15%. Research tends to go down the drain if you have to come back at a later point in time and increase a price by more than 15%. Realize that with research, you can vary the price and offer and keep the benefits identical.

For direct response marketing, the key is a perception of the costs. If \$5.95 is perceived as substantially lower than \$6, and \$6 is about the same as \$6.95 in the people's minds, don't test the \$6. Test the \$5.95 and the \$6.95.

Another caution is to monitor results. Often companies price their direct response products extremely well, but they don't follow up to see if the actual results are matching the assumptions that they used. If the name of the game is profit, then you must do this.

Now, let's quickly look at advertising, research and testing, and the legal aspects. Traditionally, advertising has been the area for breakthroughs in direct response marketing. In the future, it's going to take a backseat to lists

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and products. However, it's still fertile ground for breakthroughs in marketing. To find these breakthroughs, test significant differences in advertising strategy. Use real differences in the approaches. Use different copywriters, initiate two or three copy strategies that you're going to test. Be careful to comply with state legal requirements for advertising or you can quickly get into trouble. However, be aggressive, otherwise you're going to find yourself mailing a legal document rather than advertising materials.

Next, research and testing is a must for future success in direct response marketing. The philosophy here is that products should meet the needs and desires of the customers. Traditionally, insurance products haven't operated that way. It's been a shelf product or a product created in the home office, that is force fed to the customers.

In direct response there are three effective tools to discern the needs and desires of the customers and then to deliver those needs and desires. These tools are specialized direct response focus group research, simulator testing, and lists segmentation testing.

Finally, legal considerations play a significant roll in direct response marketing. Next to banking, insurance is the most heavily regulated industry. Insurance direct response is generating the most activity. The key areas to monitor are trusts, disclosure, advertising and jurisdictional authority.

I hope I have given you some insight into the components of direct response marketing and how the activity in each of the areas will affect the future of the direct response distribution system.

MR. DAVID B. SCHAEFFER: I welcome the opportunity to talk to you since I believe, if I'm not stating the obvious, that actuaries are going to be the future of product development and changes in the industry.

I was asked to talk about selling insurance through financial institutions. From the industry perspective, it would appear that there are very few innovations in the area of selling insurance through banks today. This is because there is a belief that simply having a financial institution to market through guarantees success. The traditional agents fear that banks will be the cause of their ruin;

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however, the financial institution is not the key to selling insurance through banks. It is the marketing organization that makes the difference. Thus, it will be a more intelligent, more efficient distribution system that will cause the demise of the traditional agent, not the banks. The insurance companies know that they must do something about the archaic distribution system that they have built for themselves and the high distribution costs that they are locked into.

The banks find themselves in a changing business climate. At one time, they used to have a franchise, where their margins were regulated and their profits were practically assured. Bankers operated on the 3/6/3 principle. That's where they brought the money in at 3%, lent it out 6%, and were on the golf course by 3 o'clock. Now margins have been compacted by deregulation and banks find themselves having to compete for business. Sometimes a deal can come down to a 100th of a basis point. As a result, they're interested in developing fee-based income by selling insurance.

Banks have a ready made distribution system for companies; they are a place of frequent client contact through their core business, they provide a method of payment, and the bank does not need the same type of commission that a traditional agent would, because they are used to dealing on thinner margins.

As a result, the acquisition costs of a product should be reduced when insurance is sold through banks and be reflected in the pricing of the product. This creates a reason for people to buy insurance from their bank. There has been a consumer benefit created. How is that expressed to the consumer? How does the message get to them? First of all, when you study the cost of buying insurance, it becomes evident that the highest cost for the consumer is the shopping cost: having to become an insurance expert once a year, trying to understand what the market is, who's the cheapest, who will pay their claims, where they will be best served. Through the affinity of their bank and the warranty that is implied by offering this service through the bank, the shopping cost is reduced for the customer.

The customer's thinking is that the bank has done the leg work, investigated the companies, and found that it is a good product. This implies to the bank customer that the people they will be dealing with are trustworthy, will be there overtime to service the business, and will be attentive to their needs.

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Most important for a successful bank insurance venture is the organization or entity that will be delivering the product. It is my belief that you cannot have an insurance company dealing directly with a bank. First of all, it's clear that one company cannot be all things to all people. In today's market, certain companies want certain types of risks while other companies are competitive in other areas. If you're going to market insurance to a bank's customers, you must have a broad range of competitive products. You can't have someone coming into a bank and have the bank say that they are good enough to hold their money, but the customer can't buy insurance with the bank. It dislodges the customer's loyalty and then you deal with the bank's problems of hurting their core business.

Another problem with banks dealing directly with insurance companies is the potential conflict of interest; the most obvious being that banks and insurance companies are well into each other's territory already. The common ground shared by both industries is primarily in the area of interest-sensitive or tax advantage products. The thought of an insurance company cannibalizing the bank's deposits, makes for an uneasy marriage.

In addition, it does not make sense for a bank to sell its customers' names for a quick list fee and then in the future have to compete with the insurance company to get back their own customers because that insurance company owns the insurance renewals.

Another problem is that traditionally, banks are not good marketers, because they've never had to be. Insurance companies aren't either because they've always used the agents to perform that function. That's why the banks need someone to work with them, to advise them on insurance, on product and marketing. It takes a different mentality to successfully develop a first generation business, especially where you're looking at two industries that epitomized the term *institution*. If you look at the new businesses that banks have gotten into recently, discount brokerage and investment banking to name but two, you'll see that the successful ones were created from someone from the banking industry as opposed to someone from inside the bank.

Commitment by the bank to the project is another important factor in a bank insurance venture. Failure is guaranteed when a bank simply says, "Fine.

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We'll accept the list fees. Here's our customer list. You, Mr. Insurance Company, come on in, mail our customer lists. Incidentally, we will sell them pen knives and night-lights or whatever we can get a list fee for." This is not building a business. The two must be integrated. This is simply just throwing short-term list income into the bank. A successful marketing operation involves a long-term relationship. I certainly don't know of any businesses that can truly be built in a year nor is that the goal of the banks. Their goal is to have a business that will create significant fee income to offset the reduced income they're getting on their core business and to help them rely less on interest-sensitive products.

In conclusion, it's clear that we're experiencing a change in the way insurance is distributed today. The existence of financial supermarkets and the fact that direct writers control over 50% of the personal lines insurance market indicate that consumer buying habits are changing.

As I said in the beginning, marketing the same old product through a financial institution will not make for a successful venture. However, by incorporating the benefits and savings that are inherent to a financial institution's distribution network and its relationship with its customers, you end up with a materially different product, which, in turn, provides a reason for people to change their buying habits.

Economics dictate what will come and what will stay in the marketplace. I believe that is the situation we're faced with here. Distributing insurance through financial institutions makes economic sense, and it is up to us, the marketers, and the designers of products to work together to develop products that incorporate these economics and take advantage of the marketing opportunity presented by financial institutions.

MR. RING: That concludes our prepared remarks, and we now invite you to ask questions or make comments.

MR. S. VINCENT ZINC: We're involved in the small group business, multiple employer trusts, and we haven't thought about group UL at this time because we're in a 25 life and under type of a marketplace. Do you see a need or a

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value for group UL in something that small, or is there a sensible benchmark say, at 50 or 100 life groups?

MR. ABRAMSON: So far, the marketplace has not come down to the very small size group. I think what happens as you get smaller in the group size is your ability to handle expenses becomes more critical. Metropolitan right now is offering the group product down to groups of 200 eligibles, which you can do in a two-plan approach, a separate UL and separate term plan. You can wind up with 10 or 15 UL certificates. It's a very standardized product. The way to administer the product has to be pretty standardized. Otherwise, if you start getting into customization, your costs go crazy on you.

MR. GARY A. FRISCH: Mr. Schaeffer, one of the biggest problems our company has in the financial institution market is the diversity of state requirements on licensing and the interaction of the agency with the financial institution. What future do you see for a little more conformity between states?

MR. SCHAEFFER: I think that through financial institutions there's the opportunity for some homogeneous legislation so that when the deregulation happens, it will be on a blanket level. In Minnesota you have a very large number of banks that are able to sell insurance right now. But as far as the Insurance Services Office (ISO) or anything like that is concerned, I really don't have a feel for how that would change.

MR. ALDEN W. BROSSEAU: Mr. Hill, I'm surprised at your optimism about the traditional agency system. If you ignore the old business, whose profits are masking what's really happening and just look at the new business being written today, very heavy investment vehicles with shrinking margins, you have to compete with investment vehicles in other businesses that don't carry the loads that we carry and don't have to support the low agent productivity that we have. I'm puzzled by the optimism. What's happened? Has the productivity increased, or are you seeing something that we're not seeing?

MR. HILL: Well maybe I'm an optimist to start with. I'm not saying there aren't challenges. Yes, productivity has increased. We feel that the multiline approach has been very helpful in terms of pushing more product through a single agent; in other words, an agent being able to sell property and casualty

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insurance, life insurance, mutual funds, annuities, certificates of deposit (CDs), etc., in one household provides the opportunity for greater productivity.

Margins are thinner, agreed, but certainly we feel that over the last few years we have been able to maintain our profitability even given the margins in the new products because of higher productivity levels. So, my optimism depends on higher productivity levels.

MR. BRADLEY M. SMITH: Mr. Hill, it seems clear that a marriage of the direct response discipline and the agency distribution system would be beneficial to both groups and to the industry as a whole. In the past it has not occurred because of territorialism or protectionism on the part of the agency group. Do you see a lessening of that in the future?

MR. HILL: Well, we have done some direct response, but I'm not sure I see a lessening of the conflict. The fit that seems to work better is more of a direct mail kind of approach where the responses lead to agent contact. Now, that's a different kind of marketing, but we certainly are doing more and more of it. I think what Mr. Ring was saying is perhaps that there are some people who respond more to direct response than they do to agent contacts, and I suppose there always will be some segment of the population like that.

There is something of a challenge in having a career agency system, particularly one like ours, doing direct response. But, the agency system has learned, both in Prudential and in other areas, they have to accommodate, to some degree, conflicts within or competition in terms of distribution, and I think we're going to see more of that in the future.

MR. RING: I'd also like to comment on that, Mr. Smith. I think the conflicts are more imaginary than real, particularly if you intend to design your direct response distribution system to go after those markets and to market those products that don't compete with the agency system.

MR. HILL: I think you mentioned that the agents do well in the upper markets, not quite so well in the middle markets, and there isn't a whole lot in the lower markets. There's no need to abandon the lower markets with the agency distribution system when direct mail can do a job there.

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You may also find it very interesting that when individual line policyholders have been mailed supplementary direct mail products, there has been an increase in agent sales. For example, you can take 200,000 names, split them, every other name gets mailed a direct response product, the remaining names are not mailed a direct response product and then track agent sales on those two blocks of business for the next 90 to 120 days. That is the time period for direct mail to have an impact, and you'll see on the average about a 20% increase in agent sales among those policyholders who were mailed a direct response product.

The thing that has to be done is to get the facts out on the table and to stop dealing with the fear that direct response will deprive the agents of a livelihood or result in a bargaining unit being established. The fact is that direct response is very powerful advertising going directly into the home. I mentioned that there's only 25% - 30% of the people who want to buy and are willing to buy via the mails. At least, 70% of them want to go and see their agent. A smart agent will take advantage of these leads and some companies are now considering a direct response program to be more valuable as a lead generator than it is in developing its own business.

MR. SCHAEFFER: I can tell you that we're involved in that integration, and we're still in the process of learning the right juxtaposition between direct marketing and agent handling. But it's working very successfully for us. We don't have the same issues involved with either a company-owned agency system or even a company relying on an agency system as we are the whole distribution system. But, it is tremendously successful once you learn how to manage the information flow.

MR. LOUIS DOIRON: Mr. Abramson, do you see group UL sold through direct mail? What aspects of the product would you look at first to make it simple enough?

MR. ABRAMSON: Similar to individual UL, group UL has a lot of places where you can collect extra fees. Every plan provision that you come out with has a fee. That tends to add to the confusion, and if people don't understand something, in my opinion, they just won't buy it. Try to develop a simple sounding product. If you're trying to get certain basic protections into your product, do it all in one spot rather than try to nickel and dime people with fees associated

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with it. Make a lot of the decisions for them so that what they're looking at is something that hopefully will meet the majority of the needs of the people. For example, as to option A or option B, I would give them one choice. Pick which one you think your association is going to be more interested in, and go with that.