RECORD OF SOCIETY OF ACTUARIES
1988 VOL. 14 NO. 2

MARKETING OF NON-TRADITIONAL INSURANCE PRODUCTS

Moderator: EDWARD P. MOHORIC
Panelists: PHILIP J. BARACKMAN
ROBERT E. GRADY, JR.*
NANCIE POULOS**
Recorder: ALBERT JOSEPH ZLOGAR

- o Prepaid legal service
- o Auto clubs
- o Credit security
- o Add-ons
- o Upgrades
- o Cross-sell

MR. EDWARD P. MOHORIC: We are going to cover the topic of non-traditional marketing and non-traditional products in two ways. First, we will depart from the pure insurance area and talk about some other programs which might add value to your customer lists. The second approach will be to discuss how add-ons, upgrades, and cross-sells can be used to enhance the value of your customer.

As many of you are aware, some of the standard mass marketed products such as hospital indemnity have become more difficult to market profitably, and selling term insurance has become scarier due to the AIDS risk. Many companies are now turning to different types of products and services.

MR. ROBERT E. GRADY, JR.: How can automobile club programs be positioned as unique in essentially a commodity marketplace? I can talk about this topic because CIGNA and its predecessor company INA probably have done more wrong in forming and running an automobile club than anyone else. We introduced an auto club in 1976 because we had a real marketing need to sell cheap AD&D insurance through something other than what we had been selling it through. So we really didn't go into this program with the best of intentions. Not only that, we saw it is a golden opportunity to sell AD&D through large oil card accounts. The problem with this approach was that we already had Chevron and ARCO as customers for the AD&D insurance and they weren't altogether happy with us forming an automobile club. So we had a lot of heavy discussions with them on this topic. So as not to upset them more than they already were, we limited our marketing efforts to bank lists. We further made the mistake of deciding to private label our auto club, which has a whole set of problems which

* Mr. Grady, not a member of the Society, is President of CIGNA Direct Marketing Company in Philadelphia, Pennsylvania.

** Ms. Poulos, not a member of the Society, is Vice President and General Manager of The Signature Group's Legal Services Plan in Schaumburg, Illinois.

I will soon describe. All of this was under the guise of selling insurance. There were many problems. Some of them were:

1. The foremost reason for forming an automobile club was to sell insurance, which is a lousy premise.

2. It is a very expensive approach, and the product sold was AD&D, which did not generate enough premium to carry the costs associated with marketing an automobile club.

3. We had no experience in marketing an automobile club.

4. We had very little capital commitment -- the extent of our capital commitment was going out and buying large inventories. Also, we had no inhouse inventory control, so years later when we wrote all the inventory off, it was an eye-opener.

The final mess we got into was private labeling. It was with Citibank, which was a very good account for us. The problem with private labeling was that we wound up with a tail and a dog situation. We had all the commitments to make, and we owned the business. But Citibank, whose name was on it really perceived itself as an owner, so there was never really a situation where your customer and you could be "pleasant" to one another.

We also decided as this club rolled along to use the "more is better" approach. So we wound up with a very heavy kit, containing various other offers and goods and services, none of which counted for anything. Some of these were a goods and services catalog for travel, entertainment, and home security; a little electronic item with which you could write your name on anything in the house; a key ring that you could drop in the mailbox; luggage tags; a magazine; etc. Oh yes, we also had insurance. The club became more and more expensive, accumulated more and more inventory, and we had fewer good managers.

Finally in late 1984 we lost the Citibank endorsement. That forced us into a decision -- either close the club and sell it (it had some value), or grow it. But if we were to grow it, how were we to do it? Obviously what we had wasn't working. We saw real problems in the marketplace -- an enormous number of much better competitors. However, the size of the market was huge: there were over 153 million drivers in the country and only 32 million were members of an auto club. The downside to that was why would all of these other people join clubs? After all, there were so many astute marketers trying to get them to join. So we saw a potentially large market if we could find some ways to reach it.

There was relatively little product differentiation. Our kit contained most of the products offered at one time or another by every travel club in America. It just wasn't packaged very well. So we really couldn't differentiate to any extent. It was enormously expensive to market and fulfill. Plus we were having one of those little problems that occur in direct response now and then called attrition. We were losing members almost faster than we were putting them on the books. In fact, we discovered that the whole industry was suffering from this problem; it was a high-attrition industry. The attrition numbers were scary in the auto club industry. We found out that the high attrition was a result of service and perceived value. A lot of attrition came from the LIFO-FIFO thing: "I got this in the mail today; I'll cancel what I have and take this. It's easy to do this

since it is relatively cheap and usually paid on an annual basis, so why not just get rid of it." All of these things combine to create high attrition.

In order for anybody in CIGNA (and this is probably true in most other insurance companies) to grow something, one has to first write strategy reports and then plan from that strategy. In order to support our strategy, we decided to spend a lot of money. We spent a considerable amount on focus groups. We held them in six different areas of the country for a week at a time. Now I'm not generally a fan of focus groups, but our groups were kind of interesting. They supported just about everything we contended, so we were happy with that. More important, they revealed some things that, whether or not they were true with other automobile clubs, they seemed to be true with all of the focus groups that we held.

First we found out that unfortunately there was no consistency in age or income demographics. Second, we found a surprisingly large number of multiple buyers. In fact, 32% of all the people in the focus groups had more than one automobile club; and this didn't vary from group to group. The reasons for that phenomenon varied over the lot, but it was surprising to us to find that one-third of the people had two or more clubs.

We found out that the definition of an auto club is very clear in the buyer's mind -- he knows what an auto club is. However, he doesn't know what a travel club is -- travel clubs mean different things to different people. Therefore an approach to the marketplace such as "loading up" with auto and travel club services is probably an attrition producer. "I don't know what I'm going to do with all of this junk, so I think I'll just throw it away and quit."

We found out that the reasons for joining an auto club are generally concrete and clear (but not so for travel clubs). The reasons for joining are protection and value -- how much will be paid for towing, a locksmith, etc.

Because of what we found out in the focus groups, we decided to scrap all of our travel-related services and concentrate only on providing automobile club benefits. We focused in on five auto club benefits.

We also discovered from our focus groups that while some industry surveys indicated otherwise, price was in fact a recognizable differentiation. People did look at price. We also found out that the kit carries an enormous value. The less confusing, the more concise, the more operational the fulfillment kit is, the more likely you will keep your customer. We finally did what all good focus groups should do -- we ranked the services offered by the auto club by preference as to what the public would want.

Fifty-one percent of the general group (members and nonmembers of auto clubs) and 79% of auto club members favored towing and emergency transportation services above all others. Hotel and motel discounts were a distant second (even though they were in an automobile club, not a travel club). Fifteen percent of the general group chose this as the second most preferred benefit. The next preferred benefit was trip planning (11% of the general group). Legal defense and insurance were the least preferred benefits. So, again, much of what we were offering in our auto clubs had limited or no appeal. For example, this delightful magazine that cost about $4.00 per year per member to produce had exactly no value to the general group. On a travel club basis, surprisingly

emergency travel services were favored over hotel and motel discounts. Various travel discounts finished a distant third.

Now that we knew what people liked, we set about our strategy of forming a new automobile club. As marketers we thought the lowest priced auto club had to work and also have the best looking fulfillment kit. And because of the low price, we could not market through the traditional means. We decided not to market the auto club through the mail, at least not on a stand alone basis. This was a hard decision to make, but in retrospect, it was the best decision. We found out that by forcing ourselves not to deal with sponsors on a more traditional approach, i.e., marketing through the mail on a stand alone basis, we could become very successful as an automobile club. We are getting sponsors by the hundreds to put our auto club on their bills, in their messages to their association memberships, employer/employee payroll, etc. There are enormous opportunities out there to put your product in front of the public which cost relatively little, and in some instances nothing.

We had some money left over to start thinking about a terrific kit. We found out that we could provide a usable kit, which looked expensive, or rather, looked and felt worth a little bit more than what we were charging for the club. The kit improved our visibility because we made it more useful. We made it into a vinyl glove-compartment sized kit. It contains a pen, pencil and pad so that people can write down their mileage and other notes. It has a theft reward sticker and a members guide. Because we offer only five products within the club, it is relatively tight and usable. It has a little card which slips inside a plastic carrying case. Essentially the message is that it is simple to use.

The member can get two of these kits per family when he joins. We were able to have this fulfillment kit produced for very little money, relative to what we expected. The fulfillment houses that we use employ the handicapped who are very good and conscientious. The kit itself is made by a firm in Philadelphia. We receive a lot of favorable letters about the kit.

We were able to introduce the CIGNA auto club on a test basis in late 1986 for $10.00 per year. Our one concern was that it was too cheap. Most of the clubs in the market were between $20 and $50 per year, and to have something that was positioned so cheaply might get some doubters out there. We found that our concerns were at least partially correct. We had a lot of people calling to ask how we could sell this for $10, so we increased the price to $12 and that seemed to work!

In addressing some of our other concerns, we needed a name that would be recognized. We approached Mario Andretti and people of that ilk, all of whom were willing to lend their names to our club. But our chairman was not particularly interested in that approach, so we ended up using "CIGNA Road and Travel Club." We are not completely happy with that, but that is the way it goes in the corporate world. The name goes against some of what we learned from our focus groups regarding travel clubs. But because the marketing material is so concise and so aimed at auto and auto-related only, we have been able to overcome some of the fuzziness of the travel club name. Also, CIGNA does have more name recognition than I felt at the time, so we are getting a reasonable lift from the name. We do have a $12 club, and this is, I believe, the major thing that makes us different from the pack -- we are the lowest priced automobile club in America, and we say that proudly in all of our marketing material.

Interestingly, this club attracted wholesale buyers. We have a growing number of customers who offer our product free to their customers; for example, employers buying Christmas gifts for their employees and car dealers who give this club with an auto's warranty. We are really selling a lot of wholesale business. We call it wholesale in that we do not pay for the marketing costs. There are no marketing costs associated with our wholesale package. The wholesale distributor of the club pays for the marketing costs.

As I said previously, we do not mail this product out on a solo basis. We only sell it as a stuffer, or in a high-volume situation. It is a give-away or it is part of a premium offer for another product. We have very strict guidelines on selling the club. For example, we will not allow anyone to take this club, wrap $50 around it, and sell it with "free tickets to the birdland dance ballroom." There has to be a value that the provider of the wholesale benefit wraps around our club in order for us to allow him to sell it in that way. We might sell it to a credit card company, for example, where the credit card is free and the auto club goes along with that. We have had a lot of people try to take our club and wrap it up with very low-cost items and then sell it for a lot more money. We just won't allow that to happen.

I thought I would end with mentioning the pricing of this club in broad generalities. You would be surprised to find that the cost of an automobile club is really not related to benefits. The automobile club buyer, for reasons that I cannot figure, hardly ever uses it. You could bet on almost 15% utilization. So it doesn't take a rocket scientist to figure out that most of the cost of an auto club arises from marketing and fulfillment. And with our club, we don't have the heavy frontend marketing costs that most of our competitors have, because we don't sell it that way.

In summary, we developed the CIGNA Road and Travel Club to differentiate ourselves in the marketplace through price. We try to capture the multiple buyer -- that buyer who feels compelled to buy two or more clubs. We figured that the buyer might cancel one of the higher priced clubs and replace it with ours. I think the marketplace has reached its maximum at least currently with 30 to 40 million buyers, and everybody is trading those buyers. We try to go after the college market -- the going away to school market -- and the buyers who want the protection of an automobile club, but who do not want to pay for it. We are trying to penetrate a new market for CIGNA. Our demographics have proven that we're getting heavy response rates from a market that has not been penetrated before. And we believe it is based largely on price.

MS. NANCIE POULOS: The Signature Group is a direct response company and a wholly-owned subsidiary of Montgomery Ward. We primarily sell insurance products and continuity programs through the mail or by telephone. We operate our own telemarketing facilities, and we send out about 500 million pieces of mail per year.

We began looking at a prepaid legal product back in 1980. After a long product development process, we finally introduced it in January 1985. We have been selling this product for three years.

Whenever I talk about the prepaid legal industry, I always mention how it is a classic example of a product in the early stages of its life cycle. There are new entrants into the business (and some are getting out), the benefits are changing, and prices are still being tested in the marketplace. I can tell you what

the industry is like today, but it could change six months from now. In fact, whenever I give a presentation on this product, I have to make sure that I find out what has changed since the last presentation, since changes occur so rapidly. In one three-month period last year I had to change 50% of my material because of new entrants into the field and a new philosophy going on in the business. So, there is a lot of activity going on.

You can't talk about a legal services plan without first talking about the legal profession. I should also provide a definition of the market. The prepaid legal market is a method of organizing and financing the delivery of legal services. There are some dynamics in the legal profession that established the need for legal services plans. For one thing, the profession is very fragmented. There are over 650,000 attorneys in this country, and there are over 115,000 legal establishments. One-third of all lawyers are solo practitioners. It is a heavily regulated profession. Up until 1975 the bar associations were setting minimum amounts that attorneys could charge for certain services. Then in 1977 attorneys were allowed to advertise prices. So it has been a slow evolutionary process for this industry. With minimum prices set by the bar associations and no communication to consumers about how much legal services cost, this industry became very inefficient. That is why the organizing and financing of the delivery of legal services has been very useful. It helps get the information out to the consumer about what legal services cost. Whenever we have asked consumers, for example, what they think a simple will might cost, the price estimates are always greatly inflated. This is because there is not that much advertising. Even though attorneys have significantly increased their advertising spending over the last five years, most consumers are not reading those prices on a regular basis.

Most people have never heard of a legal services plan. However, the concept has been around a long time -- over 15 years. It has primarily been offered as an employee benefit, and about 85% of the market today is tied into the workplace. The unions have taken a very strong lead in this product, with the largest legal services plan in the country being offered by the UAW. Our trade association reports that there are 13 million people covered by a legal services plan. However, this number is actually misleading because it refers to covered individuals, not covered households. There are probably about 4.5 million households covered. I am primarily going to talk about the nonemployee market.

One of the difficulties in this business is that it is heavily regulated. The regulatory environment is rather complex. When we were getting into this market in 1985, many of the insurance departments did not have a point of view regarding whether or not the product was insurance. Today we are in 46 states, and there are a few states, some large, that do consider this product to be insurance. There is also another set of regulations that are applicable. These are the attorney-ethical considerations. State bar associations monitor the activities of attorneys to make sure that they are in compliance with the professional standards that they believe attorneys should follow. These standards may vary by state, so you have to make sure your plan is in compliance, because any attorneys participating in the program could be in violation of these ethical codes. Therefore state entry is a time-consuming process.

The growth of the prepaid legal industry followed a gradual increase in the early 1970s. In 1978, the UAW added prepaid legal as an employee benefit, and the industry has been growing rapidly since then. From 1978 through 1985 the growth was mostly associated with union plans, with either the union or the

employees paying for the benefit. I do not see future growth of the industry coming from employee benefits. Employee benefits are becoming more expensive, so new benefits such as prepaid legal are not being added. Much of the recent growth, and I believe most of the future growth, will come from direct marketed plans.

There are two major functions in operating a legal services plan: the marketing of the plan and the delivery of the legal services. Although the Signature Group handles both of these activities, typically in this industry two separate companies perform these functions and will form a joint venture to offer a consolidated plan to, for example, a bank credit card file. The providers can be a law firm, multistate law firm, or an organization that contracts with private practice law firms throughout the country and serves as an organizing and quality control mechanism for that structure of law firms. As I mentioned before, the industry is evolving. Sometimes you will find a marketer doing some of the providing activities and a provider performing the marketing. But basically, the providers are responsible for the delivery of the legal services, attorney selection, quality control, and the regulatory and compliance matters. They check attorney qualifications and handle any disputes between the member and the attorney. The marketers select what benefits they want to offer, acquire the members, and handle fulfillment, customer service, collection of dues, and billing. There are several strong direct marketers in this business and there are new entrants coming into the business all the time. The providers form joint venture agreements with marketers to package the product and then go to third-party sponsors as a team. Some providers have exclusive arrangements with marketers; however, most have multiple joint venture agreements.

In terms of benefit structure, there are two categories of benefits: prepaid benefits and supplemental benefits. Prepaid benefits are included in the price of the program. The price of these programs usually ranges from $6-$10 per month. If the members have more extensive legal needs, then they use the supplemental services. Members pay additional fees to their attorneys for these benefits.

The most common prepaid benefit is telephone advice and consultation. What these programs are selling is prevention. We want people to reach an attorney before they have a serious legal matter. If the members consult with their attorney in the early stages of a problem, then they most likely will not have to go to court and use the supplemental services. Other key benefits include document review; for example, before you sign a lease, you can have an attorney review the lease. Some plans allow in-person consultations with an attorney and simple will preparation. We find this to be a key benefit, and the biggest "hook" in these programs. Most people don't have a simple will, and they can justify the cost of the program by getting a simple will prepared.

Some programs have letters and phone calls that attorneys will make on behalf of the members. Typically what happens is that the member will call the attorney or write a letter to him. Then the attorney will give the member advice, and the member may decide to proceed. For example, for a house closing, the member may call and ask the attorney several questions and receive advice. If the member decides then to use the attorney for the house closing, which requires that the attorney leave the office and go to settlement, then this becomes a fee-generating case for the attorney.

All of the programs have some kind of set rates that they allow the attorney to charge for supplemental services. This is probably where you will see more of a difference in plans. For instance, some plans actually state what the hourly rates are. Some plans state rates as percentages off of the attorney's usual and customary rate; for example, 25% off of the attorney's usual rate. These are really two different philosophies in terms of promoting the program. Some programs also have flat fees for particular legal matters. For example, a house closing will cost $250; an uncontested divorce will cost $200. When using flat fees, you have to be careful to be able to define the particular legal matter uniformly across the country for a mass marketed program. An uncontested divorce must mean the same thing in California as it does in Illinois. Typically what the plans have done is develop their own definitions of these matters rather than let the various state laws dictate what the definitions will be. Some plans allow for contingency fees and others do not. Again, this is really where you find differences in the programs.

Another big difference in these programs is in the attorney network. These are categorized into two types. The first type is where you have a toll-free 800 number to access your attorney or law firm. Usually that law firm is referred to as the lead law firm. Occasionally you have multiple lead law firms in a given state. All of the prepaid legal benefits are provided by this 800 number law firm. If a member needs supplemental services then he is referred to a panel of attorneys, which are different law firms. There may only be 50 or 100 lead law firms, but there may be thousands of referral law firms throughout the state. The second type of attorney network is where you use local attorneys. There are variations on this. You may have it set up where you tell the member who his attorney is and the member uses that attorney for all of his needs. Or, you may have a central location where the member can call and get a claim number, and then call that attorney. You can then control utilization somewhat. These are the two general types of attorney networks. Of course, you can always find exceptions to these two types.

When you ask consumers what their criteria are in choosing a lawyer, they typically say the number of years of experience is the most important factor. The second most important factor is the specialty or concentration in which a particular attorney practices. They want to make sure the lawyer is experienced and can handle their particular legal need. Consumers also want someone who is friendly and personable so that they feel comfortable with the person. In fourth place is the level of fees charged. This was somewhat surprising to us -- we thought that fees charged would be the most important criterion.

We also asked consumers why they buy a legal services plan. About one-third buy a plan for security. People want to have a law firm that they can call. Another one-third have a current legal need, including a need for having a will prepared. The rest of the reasons varied across the board: the plans seemed inexpensive, they trust the sponsor of the plan, etc.

We do have third-party clients where we have offered our legal services plan to other non-Montgomery Ward customer bases. To third-party sponsors, the customer service aspect of the plan is extremely important. They do not want to lose a valuable banking customer because of problems with a direct marketed product -- especially a nonbanking-related product. It is still a new product. In many of the places where we go to talk about this product, we see higher levels of decision makers getting involved, because it is such a new product. Some of the customer service concerns include: What do our customer services

people do? How many customer service people do we have? What is the nature of the problems that come in? What do we do when there is a conflict between the members and the attorneys? In addition to customer service, clients will look at our marketing expertise, staying power, how much we will promote into their credit card base, the size of our investment for them, our financial stability, and how much income they can potentially receive. Clients want an aggressive, savvy marketer who is financially sound so that income can be maximized and marketing plan commitments and customer service commitments will be met. They look at benefits to make sure that their customers receive a good value. They also look at state coverage. If the client's credit card file is nationwide, they want to penetrate as much of that file as possible to maximize profit potential.

There are basically three ways of getting into this business: the wholesale arrangement, revenue sharing, and the joint venture. There are many providers out there who have multiple marketing arrangements with people. We have seen a lot of creativity in how people want to use this product. Revenue sharing is a way of having the marketer provide all of the marketing expertise and the investment, and then you share on the revenue side of that venture. There is also the strict joint venture, where you pool assets and determine what you want to do, and set up a corporation where each party brings something to the table.

An important item that I want to mention is that while we typically have not had a problem in getting the response rates to a decent level, we have seen problems with retention. This is because there is a heavy back-end commitment -- many people have access to your customer base. So you have to make sure that you balance the acquisition and the retention side of this business. You can always hype up the response, but then what happens to your retention? While some clients don't care as much about retention as response, most clients are concerned more about retention. They would almost rather depress some of the acquisition side just to make sure that they have the retention and are not just churning members through.

MR. PHILIP J. BARACKMAN: I am going to discuss the direct marketing techniques of upgrades, add-ons and cross-sells. Specifically I'd like to address the following questions: What products are best suited for these techniques? How do they enhance value to the customer? How do they enhance direct marketing profitability? And then, extending beyond the profitability question somewhat, how may they be considered in analyzing the profitability of acquiring new customers? I think the distinction between those last two will become clearer as we get into it.

Let's get started by addressing the question of definitions. I'm keenly aware that some of you may use different terms for the same definitions or have different definitions for the same terms. This seems to be endemic to the evolution of what I call "technobabble." So let's agree on some common terminology. An upgrade is simply an increase in the amount of insurance coverage of the same type. This increase may occur at the time of initial coverage. For example, telemarketing may be used to solicit higher levels of coverage from those applying for an initial basic offer. This is a front-end upgrade -- front end in the sense that it plays a role in helping to establish the initial coverage for a particular individual. Alternately an upgrade could also take the form of an additional policy or rider which increases existing coverage. This type of increase is a back-end upgrade. I want to emphasize this front-end/back-end

perspective as this will be important when we get to the profitability analysis issue. Also, this is probably somewhat unique to direct response marketing when we take a look at the relationship between acquisition costs and premium. It's something you don't run into as much in agent-sold business.

Add-ons are simply policies or riders which expand coverage by adding different types of coverage, as opposed to just increasing the level of coverage. Like upgrades, add-ons may be offered through front-end or back-end marketing efforts.

Cross-sells involve soliciting existing insureds in one line of business for coverage in another line of business. This could be considered either front-end or back-end marketing, depending on whether the point of view is line of business or total company in scope. If separate profit centers are involved it may make sense to consider it front-end.

And just to make sure you have this front-end/back-end concept straight, I'm using the term *front-end marketing* to refer to marketing related to acquiring new customers and establishing the initial coverage. *Back-end marketing* is referred more to existing customers for the purpose of increasing or expanding their coverage. This is sometimes referred to as policyowner marketing. Generally, it is not unusual for a direct marketing organization to be hitting their existing insureds with 9, 12, or 16 back-end offers per year . . . and you wonder why you receive so much mail that has to be thrown in the trash. Generally these back-end offers will involve some combination of add-ons, upgrades and cross-sells. Hopefully that is coordinated in such a way that optimizes the marketing effectiveness. Sometimes when there is a profit center orientation this coordination doesn't always take place and problems can occur.

Now let's consider what types of products are best suited for these techniques. I approach this question with some trepidation because I think the direct marketing of insurance is facing something of a product crisis. Using the product life cycle theory, one could argue that many of the products traditionally used in direct marketing are now in the mature or decline stage. What is needed now is creativity and fresh approaches in product development. I don't want to in any way limit your thinking in this area by rehashing the same few products that gave direct marketing its glorious start. Having filed that disclaimer, let's consider a few points.

Upgrades lend themselves to products that carry a variable coverage level such as life insurance, scheduled accident, travel accident, hospital indemnity, nursing care, and home health care. Front-end upgrades offer, prior to issue, to increase the level of applied-for coverage and telemarketing is proving to be effective for this purpose. In other words, you send out an offer, someone responds, you get them on the phone and try to get them to increase that insurance by some level. Back-end upgrades may respond up to 15 times better than front-end solicitations and up to 10 times better than cross-sell solicitations. This can reduce the acquisition cost relationship to premium by a similar factor, depending on persistency. However, the supply of this low acquisition cost back-end business is obviously limited unless you can keep growing the front-end business. This seems to be becoming more and more difficult to do with traditional direct response products. We will talk more about this dilemma shortly. The best response to back-end upgrade offers occurs within one year of issue of the initial coverage, and my marketing people tell me that response is

roughly twice as high as after the first year. However, even after the first year, response rates usually justify continued upgrade efforts.

Add-ons are comparable in use to riders in agent-sold marketing. Examples include adding accidental death benefits to life policies and enriching basic medicare supplement coverage with benefits for the part A deductible, skilled and private duty nursing benefits, and part B excess charges. Home health care benefits can also be used as an add-on. Add-on coverages are most profitable, entailing little additional basic administrative expense. This allows add-ons of modest premium to be viable. If add-ons take the form of separate policies then this principle tends to get violated. A very basic plan with an array of simple add-on riders allows maximum flexibility in creating product offers and incremental back-end coverage building. In addition, a portfolio of add-ons rather than combined coverages under separate single policy forms facilitates rate increases for a particular coverage. It is easier to isolate the experience, and the favorable experience of one coverage does not get to offset the coverage needing the rate increase.

Cross-sells may respond up to 2 times better than front-end offers for the same product. This makes sense in that you are dealing with names who have already responded to one of your company's products but within the context of another line of business. The response is generally lower than for upgrades, precisely because the previous response was in another line of business, not the same product. Cross-sells tend to work best between related lines of business, such as life and health, or auto and homeowners. This may be a function of some similarities of the underlying target markets, or some perceived affinity between the lines of business.

Now, I would like to talk about the question of how upgrades, cross-sells, and add-ons enhance the value to the customer of direct marketing insurance programs, and again I would like to draw a contrast with agent-sold business. Sitting at the kitchen table with the potential insured, the agent can help determine the appropriate types and levels of insurance coverage for the particular individual or family. The agent can offer alternatives using a portfolio of products and answer most questions that the prospect may have. A uniquely tailored insurance program can often be sold at the front end of the relationship between the insured and the insurance company. This efficiency in front-end marketing is not a hallmark of the direct response approach. Usually not enough will be known about the recipient of the solicitation to initially structure and offer a tailored program. Since questions cannot easily be fielded, direct marketing tends to be most successful when the offer is kept simple and requires very few decisions. Too many options distract attention from the all important decision to respond. On this account, front-end direct marketing coverage often tends to miss the mark in providing optimal value to the customer. Often this fact is rationalized by characterizing such coverage as supplemental in nature and to some extent, I think this is a valid rationalization; but increasingly, however, this is becoming a sore point for direct marketing and is drawing more and more criticism from those who are all too eager to score points by explaining the weaknesses of $5.95 per month insurance coverage.

It strikes me that upgrades, add-ons, and cross-sells can do much to address the value problem and I don't think we've really tapped the potential here. Upgrades can increase coverage levels to significant amounts. What is needed in this area however, is a transition from the guaranteed issue or simplified underwriting for initial coverage to underwriting which allows higher coverage to be

competitive in rate and level with insurance obtainable through other marketing methods. Unfortunately, I don't think we have seen much development in this area. Add-ons can add coverages for spouse and family and expand the scope of coverage for the primary insured. Cross-sells can expand the scope of coverage to other lines of business leading to a convenience value, if the efficiencies of combined billing and one-call or one-stop service are available from the insurer. One of the few points that I would like to make is that I think there is a lot of potential in upgrades, add-ons, and cross-sells to correct the value problem due to the simplicity and basic nature of the initial offer which is a fundamental characteristic of direct marketing. Maybe we can see more of a coming together of types of products and agent-sold marketing and not continue this large dichotomy between the two. Because ultimately the value to the customer shouldn't ride on how they happened to acquire the coverage.

Now let's consider the question of how upgrades, add-ons and cross-sells enhance the profitability of direct marketing. Without a doubt the chief reason for better profitability is that these techniques tend to result in a lower acquisition cost per premium dollar of new business, thus leaving a larger piece of the premium pie chart for profit.

For those of you who may be new to direct marketing, I'd like to highlight a major difference with respect to agent-sold marketing. With agent-sold marketing, the acquisition cost bears largely a predetermined and predictable relationship to the premium generated and to the pricing assumptions. With direct marketing the acquisition cost relationship is largely a function of the response to the solicitation and has a less certain relationship to premiums generated or to pricing assumptions. Therefore, techniques which lower acquisition costs relative to premiums are of special interest and importance. Upgrades, add-ons and cross-sells tend to lower acquisition costs in three ways. First, you probably won't have to pay for the use of the names to be solicited. Second, you will already know a lot about the names from existing applications and in-force records. This allows for more effective list segmentation and a better matching of names to your products. Third, response rates will be higher simply because you are soliciting only individuals who have already responded to at least one of your offers, a small but prestigious group.

A second reason why these marketing techniques may enhance profitability is that they may represent a better selection of risk. You may find that persistency is better among those responding to upgrades and add-ons since this shows a positive attitude towards your company and its products. If claims experience is used for segmentation purposes, it may be possible to select a more healthy class of risks, and thus lower the claims piece of the premium pie chart. Better profitability cannot be taken for granted, however. Higher coverage levels usually attract antiselection, so maximum coverage levels need to be chosen carefully and the resulting experience monitored. You may find that your marketers like to solicit lapsed policyholders and are getting decent response, but a look at resulting persistency experience may show that it's a losing proposition. The extreme heaping of acquisition costs to the time of issue makes profit sensitivity to persistency greater for direct response than for most other types of marketing. The actuary needs to have the ability to analyze mortality, morbidity and lapse experience by market source to have a good handle on the true profitability of upgrades, add-ons, and cross-sells. In today's competitive environment, I believe that state-of-the-art experience analysis by market segmentation parameters is more than just helpful -- it's critical to success. Just remember that without the actuarial experience, marketing will

gravitate to the best response and assume that optimal profitability is being obtained. Like the song goes, "It ain't necessarily so!"

A third reason for better profitability as a result of upgrades and add-ons is that a larger average premium per policy or account results in a larger base for spreading maintenance costs that are more a function of the number of policies than of the maintenance cost efficiency.

I'd like to turn now to the question of how upgrades, add-ons, and cross-sells may be considered in analyzing the profitability of new customers. When these techniques are used in front-end marketing, the estimates of the corresponding acquisition costs need to be reflected in the marketing plan, and the actual costs need to be associated with the new business generated. Then the profitability of the front-end business may be determined by comparing the total acquisition costs per unit with your current estimates of the relationship between profitability and acquisition costs. New annualized premium (NAP) is a good unit of new business for expressing the relationship between acquisition costs and profitability. For example, your prior analysis may tell you that an acquisition cost of 100% of new annualized premium will yield a 13% return on investment (ROI), and that 120% of NAP will yield 8% ROI, etc. When reviewing the marketing plan or actual results, a read of the acquisition cost and associated NAP can then be translated into a corresponding profitability estimate. Other profit objectives besides ROI are of course possible and even desirable. The underlying profitability analysis needs to be updated periodically to reflect changes in experience, particularly as more is learned about nuances of experience related to various market sources and marketing methods.

Sometimes instead of relating acquisition cost to profitability by expressing acquisition cost as a percent of new annualized premium, the inverse ratio is used; that is, new annualized premium to acquisition cost. This convention tends to vary by company. It's a good idea to avoid using acquisition cost per policy count, since this is much more sensitive to the difference between actual and assumed policy size.

So far we've talked about analyzing only the profitability of front-end business -- the profitability of the initial coverage of a new customer. Recall earlier that we said that the back-end business tends to be more profitable, primarily because of more marketing efficiency resulting in a lower acquisition cost. This presents a classic dilemma.

If the front-end business does not meet the profitability objective, then it might be reasonable to conclude that front-end marketing efforts should cease. However, if front-end marketing efforts were to cease, then back-end marketing, which let's assume easily exceeds the profitability objective, would then be limited in growth. This calls to mind the adage that if you can make money on razor blades, then you might want to consider giving away the razors.

There are several ways to deal with this dilemma in your profitability analysis. One would be to ignore it and hold all individual marketing efforts (other than testing) to the profitability objective. This may have been a viable approach at one time, but today this will likely cause a significant decline in new customers, and lead to a decline in total in-force business.

Another way of dealing with the dilemma is to require that the total of front-end and back-end marketing efforts within a given calendar time frame meet the

profitability objective. This approach allows a higher volume of front-end business for a company with an existing block of business, but would still tend to limit the volume of new customers for a start-up operation. This approach does not really determine the profitability of new customer relationships. And although profit objectives may be met each year, an optimal balance between growth and profitability may not be achieved. Perhaps a better way of dealing with the dilemma is to shift the profit analysis perspective away from the product and to the customer relationship. Similar to the fact that we don't analyze the profitability of a product by looking only at the first policy year, perhaps we should not analyze the profitability of a new customer relationship by looking only at the first product we sell that person -- the razor.

Although we're used to making uncertain assumptions in product profitability analysis, taking the new customer perspective means that we will have to make a few more. These essentially boil down to how much back-end business will be generated relative to front-end, when it will become effective, and how much lower the acquisition cost will be. Given these assumptions, an array of scenarios can be analyzed for profitability to give your marketers various options for planning, and for analyzing the profitability of actual results. It will be imperative to monitor the volume of back-end business and compare it to that assumed in prior profitability analyses. Variances will contribute to reassessing the profitability of acquiring new customers and improving future back-end volume assumptions.

Table 1 shows ROIs based on analyzing combined front-end and back-end business. The back-end business is assumed to be issued during the first three policy years of the front-end business, according to a certain timing pattern. This type of analysis is developed by combining profit flows from the appropriate products, in the appropriate amounts, reflecting the appropriate timing offset, and then measuring the resulting ROI or other measure of profitability. In this example, the back-end product is assumed for simplicity to be identical to the front-end product in all respects except acquisition cost and volume. Though fairly representative, results will differ significantly by such factors as benefit ratio, persistency assumptions, and expense assumptions. Do not assume that these figures are meaningful other than for illustrative purposes.

TABLE 1

RETURN ON INVESTMENT
COMBINED FRONT-END/BACK-END BUSINESS*
FRONT-END COST/NEW ANNUALIZED PREMIUM (NAP) = 120%

BACK-END	BACK-END NAP AS PERCENT OF FRONT-END NAP				
EFFICIENCY FACTOR	0	25	50	75	100%
1	8 %	8 %	8 %	8 %	8 %
2	8	10	12	14	15
4	8	11	15	18	20
8	8	12	16	20	23
16	8	12	17	21	25

* Back-end business assumed issued during first three policy years of front-end policy (timing pattern of 50%, 33%, 17%).

Note that the ratio of front-end acquisition cost to new annualized premium assumption is 120%. From the table we see that this results in a front-end profitability of an 8% ROI. The first column shows this because it is the no back-end business scenario (back-end new annualized premium is 0% of front-end new annualized premium). The first row also shows this since with a back-end efficiency factor of 1, the back-end business in this example is identical to front-end business.

Note that the back-end efficiency factor varies from 1-16. An 8 here simply means that we're assuming that the back-end business is acquired at a cost of 120 over 8, or 15%, of new annualized premium. In certain situations, the efficiency factors would equate to the response rate relationship between front-end and back-end business.

Back-end NAP as a percentage of front-end NAP varies from 0% to 100%. One hundred percent means that the results reflect an equal volume of front-end and back-end business measured in terms of NAP. This is not an absolute limit. Some types of business may have even greater back-end potential.

Let's look at the numbers in Table 1. The more back-end business that is more efficiently acquired, the greater the ROI result of the combined front/backend profit flows. Note that different combinations of back-end volume and efficiency result in a similar ROI. This gives the marketer some elbow room to develop an effective back-end marketing plan. Note too, that the efficiency factor loses impact on ROI as it increases. It could be that more should be spent on kits, telemarketing, etc., to raise back-end volume, when the efficiency gets much above 4 to 8. Look at the center column, bottom row, 17% ROI figure. If quadrupling acquisition cost could increase volume from 50% to 75%, then an 18% ROI would ensue. In some sense high back-end volume appears to be more important than a very high efficiency factor. We never get to a 15% ROI in the 25%, back-end volume column. We do get there in the 2 efficiency factor row.

We'll just take a quick look at similar tables. The only change is in the front-end cost to NAP assumption.

The front-end cost to NAP ratio for Table 2 is 140%. Note that front-end profitability has dropped to a 4% ROI. However, it may be still possible to develop a decent combined ROI.

TABLE 2

RETURN ON INVESTMENT
COMBINED FRONT-END/BACK-END BUSINESS*
FRONT-END COST/NEW ANNUALIZED PREMIUM = 140%

BACK-END	BACK-END NAP AS PERCENT OF FRONT-END NAP				
EFFICIENCY FACTOR	0	25	50	75	100%
1	4 %	4 %	4 %	4 %	4 %
2	4	6	8	9	10
4	4	7	10	13	15
8	4	8	12	15	18
16	4	8	12	16	19

* Back-end business assumed issued during first three policy years of front-end policy (timing pattern of 50%, 33%, 17%).

The front-end cost to NAP ratio for Table 3 is 160%. Note that front-end profitability has dropped to a 2% ROI. Perhaps it will be impossible to develop an acceptable combined ROI here.

TABLE 3

RETURN ON INVESTMENT
COMBINED FRONT-END/BACK-END BUSINESS*
FRONT-END COST/NEW ANNUALIZED PREMIUM = 160%

BACK-END	BACK-END NAP AS PERCENT OF FRONT-END NAP				
EFFICIENCY FACTOR	0	25	50	75	100%
1	2 %	2 %	2 %	2 %	2 %
2	2	4	5	6	7
4	2	5	7	9	11
8	2	5	8	11	14
16	2	6	9	12	15

* Back-end business assumed issued during first three policy years of front-end policy (timing pattern of 50%, 33%, 17%).

The front-end cost to NAP ratio for Table 4 is 100%. Note that front-end profitability is a healthy 13% ROI. A very attractive combined ROI develops here under any back-end scenario. May all your analyses come out looking like this one!

TABLE 4

RETURN ON INVESTMENT
COMBINED FRONT-END/BACK-END BUSINESS*
FRONT-END COST/NEW ANNUALIZED PREMIUM = 100%

BACK-END	BACK-END NAP AS PERCENT OF FRONT-END NAP				
EFFICIENCY FACTOR	0	25	50	75	100%
1	13 %	13 %	13 %	13 %	13 %
2	13	16	18	20	22
4	13	17	21	25	28
8	13	18	23	27	32
16	13	18	24	29	34

* Back-end business assumed issued during first three policy years of front-end policy (timing pattern of 50%, 33%, 17%).

Upgrades, add-ons, and cross-sells will play an increasingly vital role in the direct marketing of insurance products. What is most needed is innovative product development, sophisticated experience analysis, and sound analysis of new customer profitability.

MR. MOHORIC: When doing a lot of pricing work and writing actuarial memoranda for new products, I find that the regulatory and approval process, particularly for health insurance, is overwhelming at times. I ask Ms. Poulos and

Mr. Grady, for the prepaid legal and automobile club products, how involved is the approval process?

MS. POULOS: For prepaid legal services, the process is fairly informal so far. There are about five states that take the position that prepaid legal is insurance, and for those states you have to file the plan and include an actuarial demonstration. Many of the other state insurance departments have "no action" letters regarding this plan, stating in writing that they do not believe this product is insurance. However, the states can rescind those letters and decide to regulate the product at a later date. We have had more states reviewing their original opinions, and I believe we will see this happen more often. In summary, there are five states that regulate the product, and about five more that are looking to regulate it.

MR. GRADY: The automobile club is a general business corporation, which has its own set of regulations. There are about 17 states which require insurance department regulatory involvement. It does cost a lot of money to set up a club. There is a bonding requirement for the towing and road service benefits in some states. In general, the regulatory environment is not too difficult.

MR. KIRAN DESAI: I have some questions and comments for Mr. Barackman. You mentioned that add-on business and upgrades have better persistency and therefore add more to value. I have also found that having more than one product -- especially having three or more for the same customer -- causes the persistency to improve by itself. It's not that the selection process chooses insureds that are more likely to stay with you. Once the customer is accustomed to dealing with your company, provided your service is good, the persistency improves. My second comment is a little note of caution that we actuaries need from time to time. We should avoid the situation where you allow a higher back-end efficiency to promote a slack front-end effort. Finally, I was confused by your two-dimensional grid. I don't perceive this as two dimensional, but as a single dimension, because marketing efficiency determines what the ratio of back-end to front-end new annualized premium will be, with the sole exception of where you cut off the marketing effort because your breakeven threshold is not reached. Your ratio of back-end to front-end is predetermined, so you don't get a grid at all.

MR. BARACKMAN: The reason for the two dimensions is to emphasize the relationship between volume and efficiency. The back-end efficiency factor and back-end new annualized premium as a percentage of front-end new annualized premium are not totally predetermined or dependent. For example, the backend new annualized premium as a percentage of front-end is also a function of the number of back-end marketing efforts even though the efficiency may be constant. There are some marketing decisions that can be made that will land you on different points on the two-dimensional array. For example, you could spend more per kit and look at the impact on volume to find an optimal relationship.

MR. MOHORIC: Mr. Barackman, do you encounter any maximums in add-ons, upgrades, and cross-sells after which your lapses either don't improve or get worse? That is, if the customer ends up with several products and a lot of coverage, he may decide eventually that he is spending too much on insurance and cancel everything.

MR. BARACKMAN: I don't think we're that good yet. If you ask me next year I could probably answer that question. My company is in the process of

implementing new experience systems that will allow us to look at the business in several different ways.

MR. ANDREW J. BYRNE*: Ms. Poulos, you mentioned that five insurance departments had decided that prepaid legal was insurance. Did they decide what kind of insurance it was, and did they agree on what kind of insurance it was?

MS. POULOS: All five states independently agreed that the product had to be underwritten by a property-casualty company.

MR. BYRNE: Ms. Poulos, in your marketing efforts, did you do any broad marketing, i.e., cold calling?

MS. POULOS: Yes, we started that about a year ago and have been pleasantly surprised with results.

MS. BARBARA J. LAUTZENHEISER: Mr. Barackman, most of your comments regarding upgrades, add-ons, and cross-sells were directed towards an originally direct marketed product. I don't really see anything, however, that would be any different to using those same principles on an agency-marketed product if the agency force were comfortable with that. Everything you have said is just as appropriate for the originally agency-marketed product. Do you agree?

MR. BARACKMAN: One of the distinctions I see is that the acquisition cost relationship to the premium is more critical in direct response. On the agency side, regardless of whether it is an initial product or a subsequent offering, the acquisition cost relationship to premium doesn't tend to vary so much. With direct marketing, you have a significant lowering of the back-end acquisition cost.

MS. LAUTZENHEISER: Yes, but some of the principles apply. You are producing more income; you will have better persistency -- all of those advantages would seem to work as well with direct marketed add-ons to an originally agency-marketed product.

MR. BARACKMAN: Yes, I agree. Even in the agency context, there is a certain amount of cost related to acquiring that initial policyholder that will not be present when selling additional coverage to that policyholder.

MR. MOHORIC: You want to be careful not to upset your agents. If a direct mail upgrade to an agency-sold product is going to prompt the customer to call the agent for advice on whether or not the customer should buy the extra coverage, then the agent is going to want some commission on the upgrades.

MS. LAUTZENHEISER: Yes, but this is a function of whether your field is comfortable with the process and of how you tie your field in to the process.

MR. MICHAEL D. HOPKOVITZ**: Ms. Poulos, you talked briefly about retention rates. Could you expand a little on what kind of retention rates you have had?

* Mr. Byrne, not a member of the Society, is an Advertising Marketing Consultant in El Monti, California.

** Mr. Hopkovitz, not a member of the Society, is Assistant Vice President and Actuary with Associates Insurance Group in Dallas, Texas.

In particular, have you measured the retention on the one-third of the customers who bought the prepaid legal plan because they had a definite need in mind when they purchased?

MS. POULOS: With our product, we have almost entirely monthly credit card billing. This will result in lower retention than annual credit card billing. However, this plan has the lowest cancel rate of all our direct marketed products. We retain over 80% of our people within the first year. Regarding the second part of your question, we have not seen any significant retention difference between those customers who had a definite need and those who did not. There was some concern when we got into the business that there would be people buying into the program, getting the free will, and then cancelling out of the program, especially on a monthly billed basis. But we have not seen this occur. I believe that people who may have had the intention of cancelling early find that they like the plan and find that it is useful to them.

MR. TIMOTHY P. SCHILTZ: Mr. Grady, could you expand on your practice of not allowing your wholesale clients to sell your product for more money without adding a significant value to it? If you're getting the same price and have no marketing cost, and a company could add some item of insignificant value to the club and charge slightly more for the club, and sales are increased, why would you object?

MR. GRADY: We just thought it was inherently wrong to allow the practice, and we wanted to avoid giving the customers a bad value. If we wanted to be a $50 automobile club we would have been a $50 automobile club. We could have just as easily charged more for the club.

MR. ROBERT E. MCKEAN*: Mr. Grady, for your CIGNA Road and Travel Club, did you solicit your own customer base? If so, what were your results?

MR. GRADY: Most of our customer base is from endorsed business, so we don't own the lists. We could not solicit them without the prior approval of the endorser.

MR. CHARLES F. THALHEIMER: Mr. Barackman, you mentioned that you are using telemarketing techniques in addition to mail for add-ons and upgrades. Have you ever measured how many customers you might lose altogether as a result of what the customer perceives as being "badgered" by the company?

MR. BARACKMAN: Yes we do use telemarketing, and I can personally identify with your point when I get a call around dinnertime to upgrade my coverage! However, if you don't do any back-end efforts, then you get zero back-end premium in relation to front-end.

MR. GRADY: It is a valid concern, Mr. Thalheimer, and one I think we're all conscious of. But, on the other side, I have seen responses from some customers where they not only were not angry about the back-end calls or mail, but would send thank-you notes to the company for reminding them that inflation has indeed weakened their life insurance program and that they were unaware of it! Another point to remember is that we can get a little shy about contacting our

* Mr. McKean, not a member of the Society, is a Manager of the Special Group Department with Nationwide Life Insurance Company and National Casualty Company in Columbus, Ohio.

customers, but our competition doesn't feel that way. The competition is going to go after them, so we had better do the same.

MR. BURN: Mr. Grady, were your focus groups with prospective club members, or with actual members?

MR. GRADY: We had focus groups with members and nonmembers. We also subdivided the groups by age.

MS. LISA BRENNAN CASH: Mr. Grady, we also market an auto club through a third party, except that we do our business through agents. I was concerned with your comment that in the market surveys that CIGNA performed, legal services and insurance were the least desired categories of benefits as compared to the roadside service. Did the insurance category include hospitalization and emergency room benefits, or accidental death benefits?

MR. GRADY: Just accidental death benefits.

MR. MOHORIC: Mr. Grady, how do you handle paying the claims from your auto club? Do you have a claims department set up for this?

MR. GRADY: There are two kinds of automobile clubs: those such as AAA who have service-oriented benefits, and those such as ours with reimbursement benefits. With today's credit card-oriented society and the fact that most service stations take credit cards, I believe that the reimbursement approach is starting to become more popular than the service-oriented approach. Claims are capped at whatever limits your club has, and they come in as bills from the garage or the locksmith, for example. We pay them almost routinely, without investigating them. It is not very cost efficient to check all of them. We do, however, have a system that allows us to look at repeat claims; i.e., it will flag repeat providers or repeat users of the benefits so that if we see a pattern we investigate. But this is a very rare occurrence.

MR. MOHORIC: Ms. Poulos, is there really no insurance risk for prepaid legal because you contract out with the lawyers, i.e., the lawyers are taking the utilization risk?

MS. POULOS: That is correct. Usually there is a per capita fee paid to attorneys; for example, based on the number of people assigned to them in their geographic area. So, whether they get 100 or 1,000 calls, they get the same amount of money. They are bearing the risk for utilization.